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Entrepreneurship and Corporate Governance **Peter G. Klein**

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# FIRMS, STRATEGIES, AND RESOURCES: CONTRIBUTIONS FROM AUSTRIAN ECONOMICS

PETER LEWIN AND STEVEN E. PHELAN

Recently, scholars working in the field of modern Austrian economics have wondered about what this literature might offer for an understanding of the nature of modern business organizations (for example, Foss 1994, 1997b; Sautet 1998; Mathews 1998). In this article, we examine the received literature on firms and strategies and find that Austrian economics has important contributions to make in two particular areas—to the theory of rent and to an understanding of the meaning of equilibrium. The legacy of perfect competition casts a long shadow, inhibiting an adequate understanding of the dynamic market process in which rent is earned in disequilibrium.

Rent features as a key concept in the modern Resource-Based Theory of Strategy. This concept is borrowed from neoclassical economics but derives ultimately from Ricardo. It is used in the Resource-Based literature in a confused and inconsistent way. We examine this theory with a view to providing a more satisfactory foundation for the theory of rent, that provided by Frank Fetter, and a more satisfactory foundation for the theory of competition, that provided by Market-Process economics. The theory of the firm that emerges is, indeed, a "strategic" theory of the firm, one that depends crucially on the entrepreneur and one that is built on a thoroughly "Mengerian" (subjectivist) theory of rent.

The new Resource-Based theory (RBT) of the firm, like the Coasian literature, takes as its point of departure the neoclassical microeconomic model of perfect competition. In perfect competition there are no "profits" and all firms are identical. The RBT explains why firms differ; that is, what aspects of the perfect-competition model most plausibly do not apply. Different firms possess different (heterogeneous) resources and are (somehow) able to maintain those valuable differences (for example, Barney 1991; Foss 1997ab). As a result, according to the RBT, successful firms are able to earn "rents." This concept of rents is also derived

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from economic foundations, namely the theory of rent as developed by David Ricardo (1973) and subsequently modified by Alfred Marshall (1961).[1]

From both of these constructs, the perfect competition model and the theory of rent, it is possible to feel that the RBT has borrowed too uncritically. In the case of rent theory in particular, RBT has complicated its own framework by reproducing (or inventing) needless distinctions and overlooking others. We offer here a reformulated theory of rent derived from the work of Frank Fetter (1977). Fetter's work has been linked by Murray Rothbard to the Austrian tradition.

## RENT AND VALUE ACCORDING TO FRANK FETTER

The value of any economic organization (firm, business, company) derives from and reflects the value to it of the resources[2] under its control; that is, resources that it owns or rents. Most resources can be owned or rented, though some (like reputations) cannot be rented and others, like human capital, cannot be alienated from their owners and must be rented for wages. At any time, the *economy as a whole* will possess an inventory of potentially productive resources (that is resources that are capable of producing value). This productive potential can only be realized through the combination of these resources, often in complex ways. The values attributed to the resources, and thus to the companies that own or control them, is part of the market process underlying the formation and mutation of the resource structure. But, as we shall see, these values may look different from different perspectives and will have different magnitudes and effects depending on who is able to create them and appropriate them (in whole or in part).

From the perspective of the economy as a whole, adopting, as it were, a "God's eye" view, the value of these resources, at any point in time, can be seen as the discounted total of the (estimated) income stream attributable to them. In other words, the value of any economic resource is logically the present value of any income stream that can be attributed to the use of that resource in production.[3] That is the maximum price that anyone appraising that resource would be prepared to pay for it.[4] Anyone considering the purchase of any resource cannot avoid (perhaps implicitly) referring to the value that this resource is expected to add to economic production. Even if the resource is purchased for resale, ultimately its value must derive from some potential productive use.

---

[1] A closer disciple of Ricardo than Marshall, John Stuart Mill, writes:

> This is the theory of rent, first propounded at the end of the last century by Dr. Anderson and, which, neglected at that time, was almost simultaneously rediscovered, twenty years later, by Sir Edward West, Mr. Malthus, and Mr. Ricardo. It is one of the cardinal doctrines of political economy; and until it was understood, no consistent explanation could be given of many of the more complicated industrial phenomena. (Mill 1987, p. 425)

[2] The term "resources" has been variously used in the RBT literature. Here it is used to denote valuable assets that may be tangible or intangible (like reputations, patents, organizational routines).

[3] We use "production" here in the broadest possible sense to refer to the addition of economic value for the ultimate consumer. So, for example, distribution and marketing activities are, from this perspective, part of the productive process.

[4] We leave aside for the moment the question of how it is possible to attribute to any resource an income flow. Clearly, insofar as resources must invariably be used in combination, it is no simple matter to impute to any single resource a value for its individual contribution (how does one divide up and evaluate the contributions of individual members of a team, for example?). And the estimation of the value of any production plan is in itself a speculative matter.

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Imagine for a moment that no ambiguity or uncertainty whatsoever attaches to the production processes in the economy. All individuals possess the same hard knowledge of what resources can do and, therefore, what they are worth. In such a world, when a resource is rented its rental rate must reflect the value of the current addition it makes to the value of production (its value-marginal-product) or else the owner would be reluctant to rent it to the firm. Where the resource is not rented but is owned by the firm, the implicit "cost" of using the resource must reflect that same value. Thus there is no "surplus value" to be had, since all values are known and become incorporated into the (implicit and explicit) prices of resources. Nevertheless, in the sense advanced here, rents are earned by the factor owners.[5]

"Rents" refers here to the income streams attributable to the resource-inputs in the productive process. Resources can generally be conceived of as a stock of potential productive services. Rents are the prices paid for these services. Rents are the prices of the *flow* of services emanating from the *stock* of resources (Penrose 1995). The price of any resource stock is the discounted present value of the prices of the services it yields. In this framework, rent is nothing more nor less than the rental price of the service of a productive input. As Murray Rothbard has explained:

> We are using "rent" *to mean the unit price of the services of any good.* It is important to banish any preconceptions that apply the concept of rent to land only. Perhaps the best guide is to keep in mind the well-known practice of "renting out." Rent, then, is the same as *hire*: it is the sale and purchase of the *unit services* of any good. It therefore applies as well to prices of labor services (called "wages") as it does to land or any other factor. The rent concept applies to all goods, whether durable or nondurable. In the case of a completely nondurable good, which vanishes fully when first used, its "unit" of service is simply identical in size with the "whole" good itself. In regard to a durable good, of course, the rent concept is more interesting, since the price of the unit service is distinguishable from the price of the "good as a whole".... The price of the "whole good," also known as *the capital value of the good*, is equal to the sum of the expected future rents discounted by the rate of interest. (Rothbard 1993, pp. 417–18; emphasis in original)[6]

[5] As Rothbard has explained, from the perspective of the economy as a whole, in an economy in which from the start everything is known with certainty, the sum of all rents earned on resources that are constructed is zero since all such rents are "swept back" to the owners of the "original" factors of production. What one person pays for a piece of capital equipment, for example, a machine, will fully reflect the seller's knowledge of the discounted marginal value sum to be earned by that machine. By the same token, the prices of all of the inputs into the production of that machine will reflect their capitalized income streams in the same manner, all the way back to the original inputs. In this way, the only remaining "net" rents are those earned by the "fixed" factors of land and raw labor. And if we regard the pure earnings of labor as necessary for its existence and maintenance (reproduction), then perhaps the only "pure" rent remaining is that on land (see Rothbard 1993, chap. 5). This perspective appears to be related to Ricardo's identification of land as the only rent-earning resource, but it is not the same point, as will become clear from the discussion below.

[6] Also:

> we have been using the term *rent* in our analysis to signify the hire price of the services of goods. This price is paid for *unit services*, as distinguished from the prices of the *whole factors* yielding the service. Since all goods have unit services, *all* goods will earn rents, whether they be consumers' goods or any type of producers' goods. Future rents of durable goods tend to be capitalized and embodied in their capital value and therefore in the money presently needed to acquire them. (Rothbard 1993, pp. 502–03)

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This conclusion is not changed at all when we drop our assumption of perfect and certain knowledge. In the real world where the future is irredeemably uncertain, the value of any productive resource will still reflect the discounted value of its expected future rental stream. Certainly, different people will have different estimates of these rental streams and, therefore, will appraise differently the value of the resources that yield them. The market process of production and exchange will work in such a way that resources will tend to move to those who appraise them most highly. As mentioned above, a firm may employ resources in production by owning or renting them. If a firm decides to purchase a resource, it must do so because, in its estimation, the additional value to it of the future income streams attributable to the use of that resource meet or exceed the price paid for it. Similarly, a firm will not rent a resource unless, in its estimation, the value added to production, by combining that resource with others in the production process, meets or exceeds the rental rate asked.

This framework suggests the following conclusions:

1. There is no categorical distinction between the earnings of some resources and others; they are all rents.
2. The value of any productive resource is the discounted value of the rent streams that can be attributed to it.[7]
3. The price of any resource (and therefore, its rental stream) will be affected by its relative scarcity.

These conclusions invite a consideration of the relationship between the above treatment of rent and the rent concept as originally introduced by Ricardo and as used in the modern literature. The above approach to the theory of rent probably found its most complete and cogent expression at the hand of the early-twentieth-century economist Frank Fetter (1977) and so we shall refer to this approach as the Fetter theory.

## Ricardian and Other Rents

According to Ricardo, "rent is that portion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil" (1973, p. 33). He was concerned to explain the earnings that accrued to the different groups in society (capitalists, workers, and landowners). He tried to eliminate rent as a determinant of exchange value, so that he would be free to concentrate on the relationship between labor and capital. Thus he argued that the amount paid to the landowner was

> determined by the scarcity and differential fertility of land; it is the difference between what capital and labor can earn on the more fertile land and on land . . . which is just worth cultivating . . . but yields no surplus in the form of rent. In this respect rent differs from other forms of income: it does not enter into the cost of production for society as a whole; it cannot determine the value of corn, rather it is created by the fact that corn has value. (Winch 1973, p. xi)

[7] It need hardly be added here that there is no valid "cost of production" theory for the determination of value. All value derives from the value of final outputs to consumers. It follows then that there are no "unearned" rents in the sense of Ricardo (to be examined below) or in the sense of any "monopoly rents." All rents reflect the "value contributed" to the production process.

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The notion that land is special because it alone does not enter into the cost of production is encouraged by Ricardo's perception that land was a special and different category of input. From the perspective of the above discussion, what makes land different (in Ricardo's model) is simply that it is in fixed supply. Its supply curve is vertical. Rents are earned simply by virtue of the (fixed) existence of the resource without any action having to be taken; they are pure scarcity rents.

Marshall tried to defend and extend Ricardo's approach and it is the Ricardo–Marshall (RM) approach that is the basis for the modern treatment, including that found in the Coasian and RBT literature. Marshall recognized that the phenomenon Ricardo had identified as scarcity rents applied equally well to any factor (resource) in (temporarily or permanently) fixed supply. A scarce (unique) ability or a highly specialized machine may be valued very highly. Marshall referred to this as *quasi-rent*. It is that part of the value of the machine that is due to its temporarily restricted supply.

As it has been extended and developed further in the modern literature, the RM approach is distinguished by two key ingredients:

1. rent is a phenomenon that accrues only to factors in fixed (or "quasi-fixed") supply; and/or
2. rent is a surplus, an excess of earnings over some benchmark taken to indicate the "normal" situation.

According to the latter condition, rents are seen as "super-normal profits" or "above normal earnings." This usage derives (incorrectly) from Ricardo's observation (as noted above) that some types of land may earn more rent than others by virtue of superior fertility. If land of inferior fertility were in large abundance, it would not have any value on the market. That is to say, it would be a free good and it would not command a rental rate. The rent on the more fertile and scarce land could then be seen as a surplus for fertility, a differential payment. This seems to have created the impression in the modern literature that all rent partakes of this differential status. But in an economy where no land is free, all land is scarce and *all land earns rent*. Rent is not due to the existence of land of differing fertility. Rent is caused solely by the fact that land is scarce. *It will be paid even when all land is homogeneous* (see, for example, Mill 1871, p. 433).

It is true, of course, that differences in fertilities will result in differences in rental rates. And in many situations, it is the differences in rents that are the relevant objects of attention. In fact, in most of the modern literature the usage of rent in its various forms can be more accurately identified as *differential rent*. It is differential rent that is being sought or is in danger of being appropriated.

While we do not speculate as to how or when this particular usage got started, it is clear that:

1. It is not strictly consistent with Ricardo or Marshall.[8]

[8]An admiring textbook treatment of the subject of rent notes as follows: "There is no explicit, formal definition of quasi-rent in Marshall, and the term has been used both by him and by other writers in a variety of related but not identical senses" (Stonier and Hague 1964, p. 292). They continue, in an attempt to provide their own definition, "The quasi-rent of a machine is its total short-run receipts less the total costs of hiring the variable factors used with it and of keeping the machine in running order in the short run. In long-run equilibrium *quasi-rent will become equal to the (constant)*

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2. The RM theory itself is arguably convoluted and misleading by comparison with the Fetter theory.[9]

## RENT CONCEPTS IN STRATEGY

In the strategy literature, five different concepts of rent have been identified, namely,

- Ricardian rents,
- Marshallian (or Paretian) rents,
- monopoly rents,
- entrepreneurial rents, and
- quasi-rents.

Different theorists have defined these differently, however.[10] Inconsistency, in and of itself, is perhaps not a big problem in a rapidly developing field, particularly if there is some reason to believe that a speedy convergence to a uniform taxonomy is imminent. We believe, however, that Occam's razor suggests the adoption of an alternative simpler system, one based on Fetter's approach to the concept of rent.

The RBT of strategy emphasizes the fact that industries are populated by firms that are different (that perform differently). Indeed, it has been noted that the variance in firm performance *between* industries is, surprisingly, substantially less than that *within* industries (Rumelt 1987, p. 141). This suggests some essential *firm heterogeneity*. Firms are different because they know how to do different things (even in the production of the same or similar products) or because they have been lucky enough to stumble upon a superior technique, in short because, for one reason or another, they possess different capabilities (Barney 1986). Thus, the observation of firm heterogeneity leads naturally to the inference of *resource heterogeneity* (Barney 1991; Foss 1997b). Some firms possess things that are valuable in production that other firms do not and thus are able to outperform them. In this way, the performance of firms is tied to the earnings (rents) that can be attributed to these resources and the ability to sustain such a competitive advantage is linked to the ability of the firm to identify and protect (and perhaps extend) that essential resource heterogeneity. The theory must explain, therefore, how this is possible; that is, how it is possible that the firm may be able to successfully isolate its distinctiveness from imitation or emulation (Rumelt 1984).

The identification of distinct categories of resource rent may be seen as instrumental in this regard. If different resource characteristics give rise to different categories of rent, then this can be taken into account when formulating firm strategy. Some rents, like Ricardian rents, will result simply from the possessions of unique, non-reproducible resources; and the strategy relating to these is simply to

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*normal earnings of the machine*" (p. 93, italics added). Thus there is no suggestion here that (quasi-) rent refers to any type of surplus, though it is attributable to the fact that the machine, even in the long run, has value, i.e., is scarce.

[9]It is also true that the usage of terms relating to rent in the modern strategy and microeconomics literature is not clear or consistent (see Lewin and Phelan 1998).

[10]For example, Peteraf (1993) confounds Ricardian and Marshallian rents and uses Paretian rents as synonymous with quasi-rents, whereas Rumelt (1987) uses quasi-rents as synonymous with Marshallian rents.

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identify and protect them, ensure that they remain under the ultimate control of the firm (though it may be possible to gain from leasing them out, see Gabel 1984). Marshallian (quasi-) rents are similar except that they are attributable to resources whose supply is variable in the long run, so that an effective strategy should aim to maximize these rents by protecting them as long as possible. On the other hand, entrepreneurial rents are difficult to tie to specific resources and may inhere more in the particular combination (organization, supervision) that the entrepreneur-manager brings. In this case, the "resource" has to be "created" and then protected. The other categories of rent lead similarly to particular strategic actions; for example, protecting monopoly rents implies the maintenance of entry barriers and the exercise of market power (controlling product supply to maintain price, Peteraf 1993), while the existence of quasi-rents implies strategies (like integration) to guard against ex *post* appropriation by opportunistic trading partners.

All this is correct and helpful as far as it goes (and is discussed a little more below). An understanding of the different rent types is equivalent to an understanding of the circumstances under which they occur and can be used to suggest appropriate strategies. Ultimately, however, in every case, the existence and size of a particular rent, in the RM sense (that is in the sense used in all of neoclassical economics), boils down to circumstances surrounding the *supply of particular resources to the market and to the firm.* As explained above, in a more inclusive and helpful sense (as developed by Fetter) a rent is nothing more nor less than a resource value (or more accurately the value of the services of a resource) and all resource based strategies come down to the creation, enhancement, and protection of such values.

## RENTS AND THE MARKET PROCESS

With this in mind we may note that different economic frameworks view the discovery, generation, and capture of rent differently. In this section, we contrast an equilibrium framework (as implicitly or explicitly presumed by the neoclassical approach (and, to some extent the RBT approach) with a disequilibrium or market process approach (as derived from an Austrian-economics framework). A brief outline of the relevant ingredients of the market-process approach follows.

### *Rent and Equilibrium*

Consider the relationship between rent and equilibrium. If equilibrium is understood as a situation of consistent and correct plans and expectations (Hayek 1937; Lewin 1997a), then it can be argued that the rent that matters for strategic decisions is rent that is earned in disequilibrium—call this *strategic rent.*[11] In equilibrium, all rents are uniformly capitalized and no strategic opportunities exist. This follows from considering the relationship between rent and resources as discussed above. If the price of any resource reflects the discounted value of its expected future earnings, and if everyone shares the same correct expectations, then that price will include all correctly anticipated value components. There are no strategic decisions to be made. *Ex ante* values will turn out to be equal to ex *post* values. There will be no "surplus" or "abnormal" rents, because all resource owners, whether they sell or

[11]We use the word "strategic" here in a manner different from its use in Game Theory, where it can refer to actions taken in an equilibrium playing out of certain "strategies." We are referring to situations in which the outcomes are radically uncertain as requiring "strategic decisions."

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rent their resource, will correctly impute any value added by their resource to any production process of which they (the resources) are a part. Resource owner users will thus treat these rents as a cost. There is no discrepancy between total cost and total revenue and both equal total rents earned. Thus strategic rent, rent that follows from a discovered discrepancy between revenue and cost, and is therefore equal to what we normally understand as profit, applies only to disequilibrium situations. But since equilibrium, as defined above, is a very rare event, we should expect strategic rent to be quite common. Disparate expectations provide the opportunity for strategic rents (for different appraisals of the worth of resources).

*Resources as Capital*

We may see this more clearly if we reformulate our framework slightly. All resources may be seen as a type of "capital." Their prices are the capitalized values of their expected future rents. Value gets created by entrepreneurial decision makers who form new *capital combinations* (Lachmann 1978, Lewin 1997b, 1998). From this perspective, the particular organizational form in which the capital combination exists may be seen as a resource if it adds value to the productive process. That is, since organization matters for productive value it is a resource. Resources in general may thus be seen as part of an intricate capital structure composed of heterogeneous capital goods.

Like Schumpeter, Lachmann envisages production as a process driven by the entrepreneur who forms new and continually changing *capital combinations.* Within these combinations the individual capital items (resources) stand in complementary relationships to each other. They are joint inputs into the achievement of a production plan in the broadest sense. When the plan fails in part or in whole, the entrepreneur has to adapt by making *substitutions.* Thus, substitutability and complementarity are not so much attributes of capital resource inputs (as in neoclassical economics with its emphasis on equilibrium) as they are of states of the world. Complementarity is a feature of *stability*, substitution is a feature of *change*. Together they describe two aspects of the capital structure (broadly understood), its resilience and its flexibility.

When substitutions have to be made, the entrepreneur must change the capital combination in a manner dictated by the physical and institutional constraints. Some resources will have only one use and will be rendered useless by the change. Their value will fall to zero. These, as explained, are completely specific resources. Most resources will have more than one use (they are characterized by multiple specificity). The more adaptable a resource, the greater its value in alternative uses. A resource that has to be sold for scrap in the face of change has limited uses, while a resource that can be used in a variety of alternatives (an opera house that can be turned into a movie theater) is more resilient.

*Heterogeneity Matters only in Disequilibrium*

Clearly, heterogeneity, and the complementarity that it implies, are relevant only in conditions of disequilibrium. In equilibrium where no unexpected changes occur, the capital structure will be perfectly sustainable requiring no changes. In this way, heterogeneity and change are intimately related. Only if *ex ante* values (as seen by someone in the market) turn out to be different from *ex post* values, will heterogeneity matter. If the values of all resources turn out as expected, their heterogeneity would have no strategic significance. But in the absence of equilib-

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rium, the heterogeneous nature of resources significantly reflects the fallible decisions of the past as well as the possibilities and constraints of the future.

So, in a fundamental sense, it is the *heterogeneity of expectations* that matters more than the heterogeneity of resources as such. Heterogeneous resources give rise to differing expectations of their worth as conceived in various possible capital combinations. Those expectations that turn out to be correct give rise to strategic rents.

*Rent and Opportunism*

Opportunistic behavior or the potential for opportunistic behavior is a key ingredient of the transaction-cost approach to the theory of the firm (Klein et al., 1978; Williamson 1985, for example). From the above discussion, however, it should be clear that while the presumption of the potential for opportunistic behavior (shirking, holdups, etc.) may shed considerable light on the existence of the firm as a vertically integrated productive unit, or on productive organizational arrangements more generally, *this can never have any strategic implication in the absence of disequilibrium*. In other words, opportunism matters only if there is a divergence of expectations. It is true that this literature places some emphasis on the existence of *asymmetric information*; that is, the possession of different information by different trading parties. But this asymmetry is strategically irrelevant unless it gives rise to a divergence of expectations between the parties.

For example, if both the buyer and the seller confidently expect the buyer to appropriate the enhanced value of a constructed specific resource by "holding up" the seller after the asset has been constructed, and if both believe that a contract to prevent this is unenforceable or insufficient (incomplete) (Hart 1995), then either integration will occur or the transaction will be abandoned or the opportunism will be tolerated, whichever is most economical. The point is, there is no disagreement about which alternative is the most economical (efficient) and, therefore, no real strategic questions arise, only potential ones. If, however, there are *asymmetric expectations*, one of the parties will turn out to be wrong and the value of the resource will turn out to be different from that expected by at least one party. That difference is a strategic rent. For example, the buyer may have a different "vision" (Penrose 1995) of the potential use of a particular resource that the seller does not share because he has less or different information, or, more significantly, because he *interprets the same information differently*. If the buyer turns out to be correct, he will have earned a profit, a strategic rent, the difference between the *ex ante* price paid for the resource (built by the seller), his cost, and the *ex post* value to him of the resource, as reflected by its contribution to his revenue. Of course, the buyer too may be (pleasantly) surprised if the *ex post* value of the resource turns out to be even higher than he expected, but this has no strategic implication since, there being no expectation of this enhanced value, it could not have been part of his strategic behavior. It is a windfall gain; a profit, but not a strategic rent. Thus, not all rents earned in disequilibrium are strategic rents, but all strategic rents are earned in disequilibrium.

Furthermore, there is an important sense in which the existence or absence of potentially profitable opportunistic behavior cannot, *in itself*, be an explanation for the existence of the firm. All businesses surely have their origins in the resources of the entrepreneur (innate or otherwise) and the resources that the entrepreneurial team controls or creates, can potentially acquire, and finally combines. From this

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perspective, the existence of potentially appropriable rents is logically subsequent to the perception of a potential profit. All profitable business ventures must trace back to some differential insight or some unexpected event. There must first be the perception of a potentially appropriable rent before the question of organizational arrangement can be relevant. And this perception must signal the "discovery" of some undervalued resource or resource *combination that was hitherto unperceived.*

> What makes profit emerge is the fact that the entrepreneur who judges the future prices of the products more correctly than other people do buys some or all of the factors of production at prices which, seen from the point of view of the future state of the market, are too low. Thus the total costs of production—including the interest on the capital invested—lag behind the prices which the entrepreneur receives for the product. This difference is entrepreneurial profit. (Mises 1980, p. 109; see also Sautet 1998)

Once a potential profit is perceived by at least one person, the question then arises as to which organizational arrangement is best suited to its appropriation or renders it vulnerable to appropriation by others. We discuss this further in the next section.

*Time and Knowledge in the Market Process*

All this points to the role of time and knowledge in the market process. The process is a disequilibrium process in the sense that it is driven by the continual arrival of new knowledge (and thus the falsification of old expectations). It is almost inconceivable that the passage of time should not imply some form of learning. Time and knowledge belong together. "As soon as we permit time to elapse, we must permit knowledge to change" (Lachmann 1976, pp. 127–28). Real time, as opposed to mathematical time, is suffused with unique unanticipatable events. At the very least, this insight is an implication of the observation that at any given point of time, different individuals have different expectations, so that all but one of them are bound to be falsified. Individuals are bound to learn by the passage of time.

Related to this is the importance of recognizing the private nature of knowledge. While information (data) has objective existence, knowledge is inescapably personal (Fransman 1994). The same information is often interpreted differently by different individuals. Knowledge is different from the information from whence it derives. This means that different individuals appraising the same resources may perceive different uses and expect different earnings; in short, the same resources may have different values for different individuals. Without differences of opinion there is no market process.

Knowledge, in fact, *is an additional and necessary dimension attaching to every resource.* Without the "knowledge" of how to profitably use a resource, it is not a resource, it has no value. Resources without knowledge have no meaning. And given the personal and often idiosyncratic nature of knowledge, it appears to us that the "knowledge based" variant of the RBT (Libeskind 1996; Grant 1996; Conner and Prahalad 1996) has considerable merit. Firms and other forms of business organizations (joint ventures, business alliances, arms length contracts, etc.) serve as experimental incubators for the entrepreneurial visions of various and varied resource combinations that reflect the particular knowledge and expectations of their designers.

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## Strategic and Other Rents

From the market process perspective then, rents may be revealingly divided between strategic rents and all other rents. Strategic rents are profits and are earned only in disequilibrium. (Profits are the difference between the *ex ante* prices [values] of resource stocks, their costs, and their *ex post* value in use, the revenues they generate.) A summary appears in Table 1.

**Table 1**
**Rents in Equilibrium and Disequilibrium**

| *Source of Rent* | *Equilibrium Rents* | *Schumpeterian-Disequilibrium Rents* |
|---|---|---|
| 1. Ricardian | Rents earned from resources in absolutely fixed supply | Differential rents earned from the "discovery" of new resources in absolutely fixed supply |
| 2. Marshallian (quasi-rent) | Rents earned from resources in relatively fixed supply | Differential rents earned from the "discovery" of new resources in relatively fixed supply |
| 3. Opportunistic | No rents earned | Differential rents earned (extracted) from the "superior" insight into the value of resources in alternative uses |

This table shows the result of adding another dimension to the usual taxonomy of rents found in the RBT literature, the dimension of equilibrium and disequilibrium states. The addition of this dimension allows one to view strategic rent-earning as a dynamic process in real historical time. Schumpeterian rents, from this perspective, include all rents earned in disequilibrium. They encompass Ricardian, Marshallian, opportunistic, and any other imaginable rents in disequilibrium situations. The key aspect of Schumpetarian rents is that they arise from innovation, from the introduction of something new. "[I]n capitalist reality as distinguished from its textbook picture, [the] . . . kind of competition which counts [is] the competition from the new commodity, the new technology, the new source of supply, the new type of organization" (Schumpeter 1947, pp. 84–85, quoted in Penrose 1995, p. 114n).

Ricardian rents may be understood to refer to rent from resources in absolutely fixed supply, i.e., with vertical supply curves (a Picasso painting, a unique location, a unique talent). In equilibrium, the value of these resources is known to everyone and the institutional environment, the configuration of ownership rights, is likewise known and accepted. By definition of equilibrium, there is no decision that needs to be taken to extract and protect this value. All actions are a sort of mechanical playing out of the already determined efficient steps that must be taken by resource owners to extract maximum rents. All relevant decisions must have been taken prior to the establishment of equilibrium.

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By the same token, where a Ricardian resource is newly discovered or created or where a new method of protecting its value (restricting the use of its services) is found, a Schumpeterian innovation has been made. This shows up in an increase in the *ex post* recognized value of the resource that, in our story, should be thought of as a strategic rent. Once introduced, strategic rents become embodied in the rent stream and in the absence of further changes (innovations) lose their strategic character.

Similarly, Marshallian rents, those that can be imputed to any resource in less than infinite supply (relative to the demand), may be strategic or otherwise. As with Ricardian rents, where a resource is newly discovered or created or where a new method of protecting its value (restricting the use of its services) is found, a Schumpeterian innovation has been made. This shows up in an increase *in* the *ex post* recognized value of the resource and is a strategic rent.

The key general distinction is whether or not the value of the resource is a matter of uniform agreement or whether, as explained, because of differences of opinion (of judgment) or because of unanticipated events, there exists a wedge between the *ex ante* appraisal and the *ex post* realization of some traders in the market. Wherever there is room for the exercise of judgment, there exists the potential for the earning of strategic rents.

A consideration of the question of so called "opportunistic rents" raises related questions. Earnings from opportunistic behavior arise because of time and information asymmetries. Time asymmetries refer to the widely noted potential that exists, whenever some fixed co-specialized investment of a specific nature is made by more than one party, for opportunistically changing the nature of the agreement for sharing the fruits of that investment. This potential arises because of the "irrelevance of sunk costs." Since the value of the resource in alternative uses (by alternative users) is less than in its current use, a potential exists for one of the parties to "blackmail" the other for an amount up to the difference between the value of the resource in its current use and its value in the next best use, by threatening to withdraw the co-specialized resources necessary for the achievement of the full value of the project. This is sometimes (confusingly) referred to as an "appropriable quasi-rent." It exists because the only costs that matter for decisions are opportunity costs; that is, the value of alternatives to be sacrificed. *Before* a specific investment is made, resources could be committed elsewhere. However, *after* the investment is made this is irrelevant, since the alternative to commit them elsewhere no longer exists even if they end up earning less than anticipated. The only alternative that remains is the re-deployment of the constructed specific asset. This is an essential time asymmetry.

This time asymmetry is not sufficient, however, for the existence of an appropriable rent. There must also be a particular information asymmetry, and this is the key to an Austrian theory of the firm. If both parties are equally aware of the potential for *ex post* opportunism and to the same extent, then this, as explained earlier, *will already be reflected in the value of the resources*. Thus, in equilibrium, where all parties share the same expectations, there can be no opportunistic rents actually earned. In a disequilibrium situation, however, where the parties will have different opinions as to the values of resource combinations, such opportunities will be manifest. An optimistic, visionary, entrepreneur who values resources more highly than the owners from whom he rents them, and who turns out to be right, is

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vulnerable to being held up by the resource owners, *once the enhanced value of the resources becomes apparent.* He will attempt to take steps to protect himself by fashioning an appropriate organizational structure. But even if he is unsuccessful, the rents earned by him or by the opportunistic owner will be Schumpeterian in nature. They are the result of "superior" insight, of an innovative combination or use. Hence, we conclude that *in order for opportunistic rents to exist some value must have been entrepreneurially (strategically) added.* This is the ultimate explanation of the firm, i.e., the value added by the particular combination of resources *and the way in which they are organized.*

Insofar as strategic rents are the product of a dynamic market process, the calculus of neoclassical microeconomics is not immediately relevant to them. In a disequilibrium situation, the cost curves as depicted, for example, by Peteraf (1993) are as much a matter of judgment as the demand curves, and the costs that matter are those that apply to anticipated rather than to historical events. They include so-called "dynamic transactions costs" (Langlois 1991; Langlois and Robertson 1995) of not correctly anticipating and providing for future resource needs. In such a world, strategic rents can be earned by better assessing such costs.

## CONCLUSION: A TALE OF TWO WORLDS

In this article, we have examined and reformulated the theory of rent and related it to the concept of equilibrium and the theory of competition in order to arrive at a more consistent and satisfactory basis for a theory of the firm. Such a theory is necessarily a strategic theory. Firms are formed in order to realize, and perhaps protect, the creation of value. Table 2 summarizes the differences in the two perspectives we have been analyzing, the neoclassical-microeconomic perspective (using the RM approach to rent) and the market-process perspective (using the Fetter approach to rent). In a neoclassical world, rents indicate "unsolved" or unexploited "inefficiencies." This is because every hypothetical outcome is viewed against the standard of perfect competition in which all products are produced and provided to the consumer at minimum possible costs; that is, with the least sacrifice in alternative value. In this world, discrepancies in the values of resource combinations across firms is an indication of unexploited profits and, therefore, of inefficiency. This viewpoint invites a curious normative ambiguity. While an economy characterized by large profits may, in some sense, be viewed as dynamic and desirable, the large profits, at the same time, signal gross inefficiencies. While we seek the knowledge to inform business strategists in their pursuit of profit, we seek also the wisdom as economists to structure the world to ensure their elimination.

By contrast, in the market process world there is no single ideal standard by which to measure any particular outcome. All action takes place in an open-ended universe in which the future is continually being created, and in which, therefore, competition is a "discovery process" (Hayek 1978). The likelihood that the expectations of different individuals will be mutually compatible is extremely low. There is no assurance that the market will, through the competitive process, always arrive at the least costly way of doing things, but the availability of the opportunity to experiment in different means, methods, and products suggests that not only will there be pressure to keep the costs of producing any given product as low as possible, but that the choices available to consumers will tend to expand without limit. From the market-process perspective, high profits are an indicator of economic dynamism and the efficient uncovering of continually emerging profitable

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**Table 2**
**Contrasting Perspectives**

| | Neoclassical | Market Process |
|---|---|---|
| **Source** | Rents refer to *differences* in the earnings of similar resources and result from monopoly, opportunism, or innovation. | Rents are the prices of the services of resources. |
| **Equilibrium: Perfect Competition** | No rents earned. Conditions are "efficient." | Rents are the prices of the services of resources. Conditions are "stagnant." |
| **Equilibrium: Monopolistic Competition** | Rents refer to *differences* in the earnings of similar resources and result in monopoly. Monopoly rents are earned from special privileges or "barriers to entry." Conditions are "inefficient." | Rents are the prices of the services of resources. Monopoly rents are earned only from special privileges. Conditions are "inefficient." |
| **Disequilibrium** | Rents refer to *differences* in the earnings of similar resources and result from opportunism or innovation. Entrepreneurial and other rents may be earned. Conditions are "inefficient." | Rents are the prices of the services of resources. Strategic rents refer to *ex ante–ex post differences* in the earnings of resources and result from opportunism or innovation. Innovation occurs. Conditions are "dynamic." |

opportunities, unless, of course, they are the result of special privilege (legal barriers to entry). As such the market process perspective does not share the ambiguous view of profits (which are the difference between *ex ante* resource costs and *ex post* resource values) characteristic of the neoclassical approach. A market-process approach is thus not only more "realistic," it is surely better suited to an understanding of the origins and workings of the real-world business organizations we call firms.

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# ENTREPRENEURSHIP AND CORPORATE GOVERNANCE

PETER G. KLEIN

In his "closing salvo" in the socialist calculation debate, Mises (1949, pp. 705–10) argued that the market socialists failed to understand the role of financial markets in an industrial economy. Even with markets for consumer goods, he explained, socialism would fail because it substituted collective ownership of the means of production for private capital markets. Through these markets, owners of financial capital decide which firms, and which industries, receive resources to make consumer goods. In a modern economy, most production takes place in publicly held corporations. Of prime importance, then, is the problem of *corporate governance*: How do owners of financial capital structure their agreements with those who receive that capital, to prevent its misuse? Unfortunately, there exists little research in this area from an Austrian perspective.

In this article, I focus on the financial-market entrepreneur—what Rothbard (1962, 1985) calls the *capitalist-entrepreneur*—to outline some features of an Austrian theory of corporate governance. I begin by reviewing the traditional, production-function theory of the firm and suggesting two alternative perspectives: that of the entrepreneur and that of the capitalist. I next discuss the Coasian, or "contractual" approach to the firm and argue that it provides a useful organizing framework for Austrian research on the firm. The subsequent section proposes entrepreneurship and economic calculation as building blocks for an Austrian theory of the firm. Finally, after a brief review of capital-market behavior and the disciplinary role of takeovers, I outline four areas for Austrian research in corporate governance: firms as investments, internal capital markets, comparative corporate governance, and financiers as entrepreneurs.

## THE TRADITIONAL THEORY OF THE FIRM

In economics textbooks, the "firm" is a production function or production possibilities set, a "black box" that transforms inputs into outputs. Given the existing state of technology, the prices of inputs, and a demand schedule, the firm maximizes money profits subject to the constraint that its production plans must

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be technologically feasible. The firm is modeled as a single actor, facing a series of uncomplicated decisions: what level of output to produce, how much of each factor to hire, and the like. These "decisions," of course, are not really decisions at all; they are trivial mathematical calculations, implicit in the underlying data. In the long run, the firm may choose an optimal size and output mix, but even these are determined by the characteristics of the production function (economies of scale, scope, and sequence). In short: the firm is a set of cost curves, and the "theory of the firm" is a calculus problem.

While descriptively vacuous, the production-function approach has the appeal of analytical tractability along with its elegant parallel to neoclassical consumer theory (profit maximization is like utility maximization, isoquants are indifference curves, and so on). Nonetheless, many economists now see it as increasingly unsatisfactory, as unable to account for a variety of real-world business practices: vertical and lateral integration, mergers, geographic and product-line diversification, franchising, long-term commercial contracting, transfer pricing, research joint ventures, and many others. The inadequacy of the traditional theory of the firm explains much of the recent interest in agency theory, transaction cost economics, the capabilities approach, and other facets of the "new institutional economics."[1]

A more serious problem with the traditional theory, however, has received less attention. The theory of profit maximization is nearly always told from the perspective of the *manager,* the agent who operates the plant, not that of the *owner,* who supplies the capital to fund the plant. Yet owners control how much authority to delegate to operational managers, so capitalists are the ultimate decisionmakers. To understand the firm, then, we must focus on the actions and plans of the suppliers of financial capital.

Focusing on capital markets and the corporate governance problem highlights a fundamental analytical problem with the traditional approach to the theory of the firm. In the production-function approach, money capital is treated as a factor of production. The manager's objective is to maximize the difference between total revenues and total costs, with the cost of capital treated simply as another cost (and typically assumed to be exogenous). The residual, "profit," is retained by the manager. Hence financial capital receives scant attention. As discussed below, this can be a serious flaw.

## TWO ALTERNATIVE PERSPECTIVES

What, then, is the proper way to understand the business firm? Two alternative perspectives deserve consideration. The first perspective, which has received substantial attention in the Austrian literature, is that of the entrepreneur, or what Mises (1949, pp. 254–55) calls the "entrepreneur-promoter." Entrepreneurship, in the Misesian sense, is the act of bearing uncertainty. Production unfolds through time, and thus the entrepreneur must purchase factors of production in the present (paying today's prices, which are known), in anticipation of revenues from the future sale of the product (at tomorrow's prices, which are uncertain). Entrepreneurial profit or loss is the difference between these revenues and the initial outlays, less the general rate of interest. As such, profit is the reward for successfully bearing uncertainty. Successful promoters make accurate forecasts of future

[1] For recent surveys of this literature see Furubotn and Richter (1997), and Klein (1998a).

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prices and receive returns greater than their outlays. Those whose forecasts are less accurate earn losses. Promoters who systematically make poor forecasts quickly find themselves unable to secure any further resources for investment and eventually exit the market.

The second perspective is that of the capitalist, the owner of the firm. Ownership can also be thought of as a factor of production—what Rothbard (1962, pp. 538–41) calls the "decisionmaking factor"—but it is different from the other factors. In an ownership approach, money capital is treated as a unique factor of production, the "controlling factor"; the investor is both ultimate decisionmaker and residual claimant. The firm's objective is to maximize the return on the owner's investment. Because the owner delegates certain functions to managers, a central focus of the theory of the firm becomes the problem of corporate governance: How do suppliers of capital structure their arrangements with managers in a way that maximizes their returns?

This article argues that the most interesting problems in the theory of the firm relate to the intersection between the entrepreneurial function and the capitalist function. Indeed, as Mises argued, the driving force behind the market economy is a particular type of entrepreneur, the capitalist-entrepreneur, who risks his money capital in anticipation of future, uncertain, returns. Moreover, as discussed below, the entrepreneur is nearly always also a capitalist, and the capitalist is also an entrepreneur.

Economists now increasingly recognize the importance of the capitalist in the direction of the firm's affairs. In the introduction to his influential book *Strong Managers, Weak Owners,* Mark Roe (1994, p. vii) makes the point succinctly:

> Economic theory once treated the firm as a collection of machinery, technology, inventory, workers, and capital. Dump these inputs into a black box, stir them up, and one got outputs of products and profits. Today, theory sees the firm as more, as a management structure. The firm succeeds if managers can successfully coordinate the firm's activities; it fails if managers cannot effectively coordinate and match people and inputs to current technologies and markets. At the very top of the firm are the relationships among the firm's shareholders, its directors, and its senior managers. If those relationships are dysfunctional, the firm is more likely to stumble.

As Roe suggests, the relationships between the firm's owners (shareholders) and its top managers are centrally important in determining firm performance.[2]

## THE CONTRACTUAL APPROACH

Both the entrepreneurial perspective and the ownership perspective can be understood from within the "contractual" framework associated with Coase (1937). Coase was the first to explain that the boundaries of the organization depend not only on the productive technology, but on the costs of transacting business. In the Coasian framework, as developed and expanded by Williamson (1975, 1985, 1996), Klein, Crawford, and Alchian (1978), Grossman and Hart (1986), Hart and Moore (1990), and others, the decision to organize transactions within the firm as opposed to on the open market—the "make or buy decision"—depends on the

[2]For recent surveys of the literature on corporate governance see Gilson (1995), Shleifer and Vishny (1997), and Zingales (1998).

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relative costs of internal versus external exchange. The market mechanism entails certain costs: discovering the relevant prices, negotiating and enforcing contracts, and so on. Within the firm, the entrepreneur may be able to reduce these "transaction costs" by coordinating these activities himself. However, internal organization brings other kinds of transaction costs, namely problems of information flow, incentives, monitoring, and performance evaluation. The boundary of the firm, then, is determined by the tradeoff, at the margin, between the relative transaction costs of external and internal exchange. In this sense, firm boundaries depend not only on technology, but on organizational considerations; that is, on the costs and benefits of various contracting alternatives.

Economic organization, both internal and external, imposes costs because complex contracts are usually *incomplete*. The transaction-cost literature makes much of the distinction between complete and incomplete contracts. A complete contract specifies a course of action, a decision, or terms of trade contingent on every possible future state of affairs. In textbook models of competitive general equilibrium, all contracts are assumed to be complete. The future is not known with certainty, but the probability distributions of all possible future events are known.[3] In an important sense, the model is "timeless": all relevant future contingencies are considered in the *ex ante* contracting stage, so there are no decisions to be made as the future unfolds.

The Coasian approach relaxes this assumption and holds that complete, contingent contracts are not always feasible. In a world of "true" (structural, rather than parametric) uncertainty, the future holds genuine surprises (Foss 1993a), and this limits the available contracting options. In simple transactions—for instance, procurement of an off-the-shelf component—uncertainty may be relatively unimportant, and spot-market contracting works well. For more complex transactions, such as the purchase and installation of specialized equipment, the underlying agreements will typically be incomplete—the contract will provide remedies for only some possible future contingencies.[4] One example is a *relational contract*, an agreement that describes shared goals and a set of general principles that govern the relationship (Goldberg 1980). Another is an *implicit contract*—an agreement that while unstated, is presumably understood by all sides.[5] Regardless, contractual incompleteness exposes the contracting parties to certain risks. In particular, investment in relationship-specific assets exposes agents to a potential "holdup" problem: If circumstances change, their trading partners may try to expropriate the rents accruing to the specific assets. Suppose an upstream supplier tailors its equipment to service a particular customer. After the equipment is in place, the customer may demand a lower price, knowing that the salvage value of the specialized equipment is lower than the net payment it offers. Anticipating this possibility, the supplier will be unwilling to install the custom machinery without

[3]What Knight (1921) would describe as "risk," rather than "uncertainty."

[4]Williamson (1975, 1985) attributes contractual incompleteness to cognitive limits or "bounded rationality," following Simon's (1961, p. xxiv) interpretation of human action as "intendedly rational, but only limitedly so." Other economists are more agnostic, assuming only that some quantities or outcomes are unobservable (or not verifiable to third parties, such as the courts), in which case contracts cannot be made contingent on these variables or outcomes.

[5]This is the sense in which Kreps (1990) understands "corporate culture."

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protection for such a contingency, even if the specialized technology would make the relationship more profitable for both sides.

One way to safeguard rents accruing to specific assets is vertical (or lateral) integration, where a merger eliminates any adversarial interests. Less extreme options include long-term contracts (Joskow 1985, 1987, 1988, 1990), partial ownership agreements (Pisano, Russo, and Teece 1988; Pisano 1990), or agreements for both parties to invest in offsetting relationship-specific investments (Heide and John 1988). Overall, parties may employ several governance structures. The Coasian literature tries to match the appropriate governance structure with the particular characteristics of the transaction.

There is some debate within the Austrian literature about whether the basic Coasian approach is compatible with Austrian economics. O'Driscoll and Rizzo (1985, p. 124), while acknowledging Coase's approach as an "excellent static conceptualization of the problem," argue that a more evolutionary framework is needed to understand how firms respond to change. Some Austrian economists have suggested that the Coasian framework may be too narrow, too squarely in the general-equilibrium tradition to deal adequately with Austrian concerns (Boudreaux and Holcombe 1989; Langlois 1994). However, as Foss (1993b) has pointed out, there are "two Coasian traditions." One tradition, the moral-hazard or agency-theoretic branch associated with Alchian and Demsetz (1972), studies the design of *ex-ante* mechanisms to limit shirking when supervision is costly. Here the emphasis is on monitoring and incentives in an (exogenously determined) agency relationship. The above criticisms may apply to this branch of the modern literature, but they do not apply to the other tradition, the governance or asset-specificity branch, especially in Williamson's more heterodox formulation. Williamson's transaction cost framework incorporates non-maximizing behavior (bounded rationality); true, "structural" uncertainty or genuine surprise (complete contracts are held not to be feasible, meaning that not all *ex-post* contingencies can be contracted upon *ex ante*); and process or adaptation over time (trading relationships develop over time, typically undergoing a "fundamental transformation" that changes the terms of trade). In short, "at least some modern theories of the firm do not at all presuppose the 'closed' economic universe—with all relevant inputs and outputs being given, human action conceptualized as maximization, etc.—that [some critics] claim are underneath the contemporary theory of the firm" (Foss 1993a, p. 274). Stated differently, one can adopt an essentially Coasian perspective without abandoning the Knightian or Austrian view of the entrepreneur as an uncertainty-bearing, innovating decision-maker.[6]

## BUILDING BLOCKS OF AN AUSTRIAN THEORY OF THE FIRM

Beginning with the basic Coasian or contractual framework, we can add two elements as building blocks to an Austrian theory of the firm: entrepreneurship and economic calculation. Entrepreneurship represents the bearing of uncertainty. Economic calculation is the tool entrepreneurs use to assess costs and expected future benefits. Consider each in turn.

[6]Foss and Foss (1998) argue, more generally, that contractual and "knowledge-based" theories of the firm are fundamentally complements, not rivals.

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*Entrepreneurship*

Entrepreneurship, in the Misesian sense, is the act of bearing uncertainty. In an ever-changing world, decisions must be made based on expectations of future events. Because production takes time, resources must be invested before the returns on those investments are realized. If the forecast of future returns is inaccurate, the expected profits will turn out to be losses. This is, of course, true not only of financial investors, but of all human actors. If the future were known with certainty, man would not act, since his action would not change the future. Thus, all purposeful human action carries some risk that the means chosen will not bring about the desired end. In this sense, all human actors are entrepreneurs.

Austrians tend to focus on this kind of pure entrepreneurship, the entrepreneurial aspect of all human behavior. In doing so, however, they often overlook a particular case of entrepreneurship, the driving force behind the structure of production: the capitalist-entrepreneur, who risks his money capital in anticipation of future events. Kirzner's (1973, 1979) influential interpretation of Mises identifies "alertness" or "discovery," rather than uncertainty bearing, as the defining property of entrepreneurship. In Kirzner's framework, entrepreneurial profit is the reward to superior alertness to profit opportunities. The simplest case is that of the arbitrageur, who discovers a discrepancy in present prices that can be exploited for financial gain. In a more typical case, the entrepreneur is alert to a new product or a superior production process and steps in to fill this market gap before others.

Kirzner's formulation has been criticized, however, for a lack of attention to uncertainty. According to this criticism, mere alertness to a profit opportunity is not sufficient for earning profits. To reap financial gain, the entrepreneur must invest resources to realize the discovered profit opportunity. "Entrepreneurial ideas without money are mere parlor games until the money is obtained and committed to the projects" (Rothbard, 1985, p. 283). Moreover, excepting the few cases where buying low and selling high are nearly instantaneous (say, electronic trading of currencies or commodity futures), even arbitrage transactions require some time to complete. The selling price may fall before the arbitrageur has made his sale, and thus even the pure arbitrageur faces some probability of loss. In Kirzner's formulation, the worst that can happen to an entrepreneur is the failure to discover an existing profit opportunity. Entrepreneurs either earn profits or break even, but it is unclear how they suffer losses.

Kirzner (1997, p. 72) argues, more recently, that entrepreneurs can earn losses when they misread market conditions. "[E]ntrepreneurial boldness and imagination can lead to pure entrepreneurial losses as well as to pure profit. Mistaken actions by entrepreneurs mean that they have misread the market, possibly pushing price and output constellations in directions not equilibrative." But even this formulation makes it clear that it is mistaken *actions*—not mistaken *discoveries*—that lead to loss. Misreading market conditions leads to losses only if the entrepreneur has invested resources in a project based on this misreading. It is the failure to anticipate future market conditions correctly that causes the loss. It seems obscure to describe this as erroneous discovery, rather than unsuccessful uncertainty bearing.[7]

[7]In his defense, it should be noted that Kirzner's (1997) remarks appear in the context of defending the equilibrating tendency of markets, against the Walrasian picture of instantaneous market

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Mises, by contrast, consistently identifies entrepreneurship with both profit and loss. "There is a simple rule of thumb to tell entrepreneurs from non-entrepreneurs. The entrepreneurs are those on whom the incidence of losses on the capital employed falls" (Mises 1951, p. 112). Moreover, while Mises indeed acknowledges the element of entrepreneurship in all human action, it is clear that the potential losses of the capitalist-entrepreneurs are particularly important:

> Mises applies the concept of the entrepreneur to all cases of uncertainty-bearing, and since laborers face uncertainty in deciding where to move or what occupation to go into, laborers are also entrepreneurs. But the most important case of entrepreneurship, the driving force in shaping the actual structure and patterns of production in the market economy, are the capitalist-entrepreneurs, the ones who commit and risk their capital in deciding when, what, and how much to produce. The capitalists, too, are far more subject to actual monetary losses than are the laborers. (Rothbard 1985, p. 282)[8]

Mises is careful to distinguish entrepreneurship from *management,* the carrying out of those tasks specified by the capitalist-entrepreneur. "[T]hose who confuse entrepreneurship and management close their eyes to the economic problem" Mises 1949, p. 708). It is the capitalist-entrepreneurs who control the allocation of capital to the various branches of industry.

It is clear from this formulation that the capitalist-entrepreneur must own property. He cannot invest without prior ownership of financial capital. Menger's (1871, pp. 159-61) treatment of production includes as entrepreneurial functions economic calculation, the "act of will," and "supervision of the execution of the production plan." These functions "entail property ownership and, therefore, mark the Mengerian entrepreneur as a capitalist-entrepreneur" (Salerno 1999, p. 30). Menger describes "command of the services of capital" as a "necessary prerequisite" for economic activity. Even in large firms, although he may employ "several helpers," the entrepreneur himself continues to bear uncertainty, perform economic calculation, and supervise production, even if these functions "are ultimately confined... to determining the allocation of portions of wealth to particular productive purposes only by general categories, and to selection and control of persons" (Menger 1871, pp. 160-61; quoted in Salerno 1999, p. 30).[9] An Austrian theory of the firm, then, is essentially a theory about the ownership and use of capital. As Yu (1998, p. 7) puts it, "the Austrian firm is a collection of capital resources."

Unfortunately, the Austrian literature on the firm often confuses entrepreneurship with innovation, strategic planning, leadership, and other functions more properly associated with management than ownership. Witt (1998a,b), for example, describes entrepreneurship as a form of "cognitive leadership." Witt (1998b) outlines a potential Austrian theory of the firm by combining recent literature on cognitive psychology with Kirzner's concept of entrepreneurship. Entrepreneurs require complementary factors of production, he argues, which are coordinated within the firm. For the firm to be successful, the entrepreneur must establish a

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adjustment. Still, the defense could perhaps be made equally well without reference to the discovery metaphor.

[8]It should be noted that bondholders, as well as equity holders, are partly entrepreneurs, since even bondholders bear some default risk.

[9]For more on Misesian entrepreneurship and its various interpretations, see also Salerno (1993, pp. 116-33) and Kirzner (1996).

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tacit, shared framework of goals—what the management literature terms "leadership." A proper Austrian theory of the firm, then, must take account of the ways in which entrepreneurs communicate their business conceptions within the organization.

The problem with this argument is that while organizational leadership is undoubtedly important, it is not particularly "entrepreneurial." Entrepreneurship has little necessarily to do with having a business plan, communicating a "corporate culture," or other dimensions of business leadership; these are attributes of the successful *manager*, who may or may not be an entrepreneur.[10] Moreover, even if top-level managerial skill were the same as entrepreneurship, it is unclear why "cognitive leadership"—tacit communication of shared modes of thought, core capabilities, and the like—should be more entrepreneurial than other, comparatively mundane managerial tasks such as structuring incentives, limiting opportunism, administering rewards, and so on.

*Economic Calculation*

All entrepreneurs, particularly capitalist-entrepreneurs, use economic calculation as their primary decisionmaking tool. By economic calculation we simply mean the use of present prices and anticipated future prices to compare present costs with expected future benefits. In this way, the entrepreneur decides what goods and services should be produced, and what methods of production should be used to produce them. "The business of the entrepreneur is not merely to experiment with new technological methods, but to select from the multitude of technologically feasible methods those which are best fit to supply the public in the cheapest way with the things they are asking for most urgently" (Mises 1951, p. 110). To make this selection, the entrepreneur must be able to weigh the costs and expected benefits of various courses of action.

The need for economic calculation places ultimate limits on the size of the organization (Klein 1996). Indeed, many writers have recognized the connections between the socialist calculation debate and the problems of internal organization (Montias 1976; Williamson 1991). Kirzner, for example, interprets the costs of internal organization in terms of Hayek's knowledge problem:

> In a free market, any advantages that may be derived from "central planning" . . . are purchased at the price of an enhanced knowledge problem. We may expect firms to spontaneously expand to the point where additional advantages of "central" planning are just offset by the incremental knowledge difficulties that stem from dispersed information. (Kirzner 1992, p. 162)

What, precisely, drives this knowledge problem? The mainstream literature on the firm focuses mostly on the costs of market exchange, and much less on the costs of governing internal exchange. The new research has yet to produce a fully satisfactory explanation of the limits to firm size (Williamson 1985, chap. 6). In Coase's words, "Why does the entrepreneur not organize one less transaction or one more?" Or, more generally, "Why is not all production carried on in one big firm?"

[10]One distinction between entrepreneurship (as uncertainty bearing) and management is that managerial functions can be purchased on the market: innovation can be outsourced to R&D labs; strategic planning can be contracted out to consultants; corporate identities, both internal and external, can be developed and communicated by outside specialists; and so on.

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(Coase 1937, pp. 42–43). Existing contractual explanations rely on problems of authority and responsibility (Arrow 1974); incentive distortions caused by residual ownership rights (Grossman and Hart 1986; Holmström and Tirole 1989; Hart and Moore 1990); and the costs of attempting to reproduce market governance features within the firm (Williamson 1985, chap. 6). Rothbard (1962, pp. 544–50) offered an explanation for the firm's vertical boundaries based on Mises's claim that economic calculation under socialism is impossible. Rothbard argued that the need for monetary calculation in terms of actual prices not only explains the failures of central planning under socialism, but places an upper bound on firm size.

Rothbard's account begins with the recognition that Mises's position on socialist economic calculation is not exclusively, or even primarily, about socialism. It is about the role of prices for capital goods. Entrepreneurs allocate resources based on their expectations about future prices, and the information contained in present prices. To make profits, they need information about all prices, not only the prices of consumer goods but the prices of factors of production. Without markets for capital goods, these goods can have no prices, and hence entrepreneurs cannot make judgments about the relative scarcities of these factors. In any environment, then—socialist or not—where a factor of production has no market price, a potential user of that factor will be unable to make rational decisions about its use. Stated this way, Mises's claim is simply that efficient resource allocation in a market economy requires well-functioning asset markets. To have such markets, factors of production must be privately owned.

Rothbard's contribution was to generalize Mises's analysis of this problem under socialism to the context of vertical integration and the size of the organization. Rothbard writes in *Man, Economy, and State* that up to a point, the size of the firm is determined by costs, as in the textbook model. However, "the ultimate limits are set on the relative size of the firm by the necessity for *markets* to exist in every factor, in order to make it possible for the firm to calculate its profits and losses" (Rothbard 1962, p. 536). This argument hinges on the notion of "implicit costs." The market value of opportunity costs for factor services—what Rothbard calls "estimates of implicit incomes"—can be determined only if there are external markets for those factors (pp. 542–44). For example, if an entrepreneur hires himself to manage the business, the opportunity cost of his labor must be included in the firm's costs. Yet, without an actual market for the entrepreneur's managerial services, he will be unable to figure out his opportunity cost; his balance sheets will therefore be less accurate than they would if he could measure his opportunity cost.

The same problem affects a firm owning multiple stages of production. A large, integrated firm is typically organized into semi-autonomous profit centers, each specializing in a particular final or intermediate product. The central management of the firm uses the implicit incomes of the business units, as reflected in statements of divisional profit and loss, to allocate physical and financial capital across the divisions. To compute divisional profits and losses, the firm needs an economically meaningful transfer price for all internally transferred goods and services. If there is an external market for the component, the firm can use that market price as the transfer price. Without a market price, however, the transfer price must be estimated, either on a cost-plus basis or by bargaining between the buying and selling divisions (Gabor 1984; Eccles and White 1988; King 1994). Such estimated transfer prices contain less information than actual market prices.

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The use of internally traded intermediate goods for which no external market reference is available thus introduces distortions that reduce organizational efficiency. This gives us the element missing from contemporary theories of economic organization, an upper bound: the firm is constrained by the need for external markets for all internally traded goods. In other words, no firm can become so large that it is both the unique producer and user of an intermediate product; for then no market-based transfer prices will be available, and the firm will be unable to calculate divisional profit and loss and therefore unable to allocate resources correctly between divisions.[11] Of course, internal organization does avoid the holdup problem, which the firm would face if there were a unique outside supplier; conceivably, this benefit could outweigh the increase in "incalculability" (Rothbard 1962, p. 548). Usually, however, the costs from the loss of calculation will likely exceed the costs of external governance.[12]

Like Kirzner (1992), Rothbard viewed his contribution as consistent with the basic Coasian framework. In a later elaboration of this argument, he states that his own treatment of the limits of the firm

> serves to extend the notable analysis of Professor Coase on the market determinants of the size of the firm, or the relative extent of corporate planning within the firm as against the use of exchange and the price mechanism. Coase pointed out that there are diminishing benefits and increasing costs to each of these two alternatives, resulting, as he put it, in an "'optimum' amount of planning" in the free-market system. Our thesis adds that the costs of internal corporate planning become prohibitive as soon as markets for capital goods begin to disappear, so that the free-market optimum will always stop well short not only of One Big Firm throughout the world market but also of *any* disappearance of specific markets and hence of economic calculation in that product or resource. (Rothbard 1976, p. 76)

"Central planning" within the firm, then, is possible only when the firm exists within a larger market setting.[13]

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[11]Note that in general, Rothbard is making a claim only about the upper bound of the firm, not the incremental cost of expanding the firm's activities (as long as external market references are available). As soon as the firm expands to the point where at least one external market has disappeared, however, the calculation problem exists. The difficulties become worse as more and more external markets disappear, as "islands of noncalculable chaos swell to the proportions of masses and continents. As the area of incalculability increases, the degrees of irrationality, misallocation, loss, impoverishment, etc., become greater" (Rothbard 1962, p. 548).

[12]Similarly, Rothbard's claim is not that because external prices are necessary for large firms to function efficiently, firms will tend to become large where external markets are "thick" or better developed. On the contrary, large firms typically arise precisely where external markets are poorly developed or hampered by government intervention; these are the kinds of circumstances that give entrepreneurs an advantage in coordinating activities internally (Chandler 1977). However, such firms are still constrained by the need for *some* external market reference.

[13]Ironically, the only reason the Soviet Union and the communist nations of Eastern Europe could exist at all is that they never fully succeeded in establishing socialism worldwide, so they could use world market prices to establish implicit prices for the goods they bought and sold internally (Rothbard, 1991, pp. 73–74). As Mises (1949, pp. 702–03) observes, "[w]ithout the aid of [world] prices their actions would have been aimless and planless. Only because they were able to refer to these foreign prices were they able to calculate, to keep books, and to prepare their much talked about plans." Indeed, traditional command-style economies, such as that of the former U.S.S.R., appear to be able only to mimic those tasks that market economies have performed before; they are unable to set up and execute original tasks (Ericson 1991, p. 21).

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Rothbard's argument about the limits to firm size has several implications for research in industrial organization and business strategy. First, all else equal, firms able to use market-based transfer prices should eventually outperform firms using administered or negotiated transfer prices. Second, innovation should be particularly difficult in industries where few of the relevant manufacturing capabilities exist in the market (Langlois and Robertson 1995). Because innovating firms are more likely to be using unique intermediate goods and production processes, innovation carries with its benefits the cost of more severe internal distortions. Economic calculation is then another obstacle the innovator must overcome. Third, the allocation of overhead or fixed cost across divisions will be particularly problematic. If an input is essentially indivisible (or nonexcludable), then there is no way to compute the opportunity cost of just the portion of the input used by a particular division (see Rogerson 1992, for a discussion of these problems).[14] Firms with high overhead costs should thus be at a disadvantage relative to firms able to allocate costs more precisely between business units. In the literature on cost accounting there has been some recent interest in "market simulation accounting" (Staubus 1986), by which firms try to assess the price at which an asset would trade in an active market, based on observed market prices and related information. Rothbard's position on the limits to firm size suggests that the market simulation approach may prove a useful accounting technique.

## Capital Markets

If the capitalist-entrepreneur is the driving force behind the industrialized, market economy, then economists should focus their attention on the financial markets, the capitalist-entrepreneur's main venue. It is here that this most important form of entrepreneurship takes place. Of course, in the traditional, production-function theory of the firm, capital markets do little but supply financial capital to managers, who can get as much capital as they wish at the going market price. In a more sophisticated understanding, managers do not decide how much capital they want; capitalists decide where capital should be allocated. In doing so, they provide essential discipline to the plant-level manager, whom Mises (1949, p. 304) calls the entrepreneur's "junior partner."

When capitalists supply resources to firms, they usually delegate to managers the day-to-day responsibility for use of those resources. Managers may thus be able to use those resources to benefit themselves, rather than the capitalist. The problem of managerial discretion—what we now call the principal-agent problem—occupies much current research in the theory of the firm. Under what conditions can managers exercise discretionary behavior? What kinds of rules, or mechanisms, can be designed to align the manager's interest with the owner's? Without effective rules, what actions will managers choose? An early application was the proposed "separation of ownership and control" in the modern corporation. Berle and Means (1932) argued that the modern firm is run not by its owners, the share-holders, but by salaried managers, whose interests are different from those of shareholders and include executive perks, prestige, and similar rewards. If the corporation is diffusely held, no individual shareholder has sufficient motivation to engage in (costly) monitoring managerial decisions, and therefore discretion will flourish at

[14] Mises (1944, p. 32) recognized the problem of allocating overhead costs, mentioning this as a possible exception to the notion that divisional accounting costs can reflect "true" costs.

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the expense of the market value of the firm. However, Berle and Means did not consider how owners might limit this discretion *ex ante*, without the need for detailed *ex post* monitoring.

Agency theory—now the standard language of corporate finance—addresses these problems. As developed by Jensen and Meckling (1976), Fama (1980), Fama and Jensen (1983), and Jensen (1986), agency theory studies the design of *ex-ante* incentive-compatible mechanisms to reduce agency costs in the face of potential moral hazard (malfeasance) by agents. Agency costs are defined by Jensen and Meckling (1976, p. 308) as the sum of "(1) the monitoring expenditures of the principal, (2) the bonding expenditures by the agent, and (3) the residual loss." The residual loss represents the potential gains from trade that fail to be realized because perfect incentives for agents cannot be provided when the agent's actions are unobservable. In a typical agency model, a principal assigns an agent to do some task (producing output, for instance), but has only an imperfect signal of the agent's performance (for example, effort). The agency problem is analogous to the signal-extraction problem popularized in macroeconomics by Lucas (1972): how much of the observable outcome is due to the agent's effort, and how much is due to factors beyond the agent's control? The optimal incentive contract balances the principal's desire to provide incentives to increase the agent's effort (for example, by basing compensation on the outcome) with the agent's desire to be insured from the fluctuations in compensation that come from these random factors.

Owners of corporations (shareholders) use a variety of control or governance mechanisms to limit the managerial discretion described by Berle and Means. Both "internal" and "external" governance may be employed. Internally, owners may establish a board of directors to oversee the actions of managers. They can use performance-based compensation to motivate managers to act in the owners' interest (for instance, giving managers stock options instead of cash bonuses). They can adopt a particular organizational form, such as the "M-form" structure, in which managerial discretion is more easily kept in check (Williamson 1975). Finally, they can rely on competition within the firm for top-level management positions—what Fama (1980) calls the internal market for managers—to limit the discretionary behavior of top-level management.

Even more important are external forces that help align managers' interests with those of shareholders. Competition in the product market, for example, assures that firms whose managers engage in too much discretionary behavior will fail, costing the managers their jobs. In countries where universal banking is permitted, large equity holders such as banks can exercise considerable influence over managerial behavior. The external governance mechanism that has received the most attention, however, is the market for ownership itself, the "market for corporate control."

Henry Manne's essay, "Mergers and the Market for Corporate Control" (1965), responded to Berle and Means by noting that managerial discretion will be limited if there is an active market for control of corporations. When managers engage in discretionary behavior, the share price of the firm falls, and this invites takeover and subsequent replacement of incumbent management. Therefore, while managers may hold considerable autonomy over the day-to-day operations of the firm, the stock market places strict limits on their behavior.

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Mises makes the same general point in the passage in *Human Action* (1949) distinguishing what he calls "profit management" from "bureaucratic management" (pp. 308–11). It is true, Mises acknowledges, that the salaried managers of a corporation hold considerable autonomy over the day-to-day operations of the firm. Nonetheless, the shareholders make the ultimate decisions about allocating resources to the firm, in their decisions to buy and sell stock:

> [The Berle–Means] doctrine disregards entirely the role that the capital and money market, the stock and bond exchange, which a pertinent idiom simply calls the "market," plays in the direction of corporate business. . . . [T]he changes in the prices of common and preferred stock and of corporate bonds are the means applied by the capitalists for the supreme control of the flow of capital. The price structure as determined by the speculations on the capital and money markets and on the big commodity exchanges not only decides how much capital is available for the conduct of each corporation's business; it creates a state of affairs to which the managers must adjust their operations in detail. Mises 1949, p. 303)

Mises does not identify the takeover mechanism *per se* as a means for capitalists to exercise control—takeovers were much less popular before the late 1950s, when the tender offer began to replace the proxy contest as the acquisition method of choice—but the main point is clear: The true basis of the market system is not the product market, the labor market, or the managerial market, but the capital market, where entrepreneurial judgments are exercised and decisions carried out.[15]

Mises's treatment of the importance of financial markets is also the key to his final rebuttal in *Human Action* to Lange, Lerner, and the other market-socialist critics of his calculation argument (Mises 1949, pp. 698–715). The market socialists, he argued, fail to understand that the main task performed by a market system is not the pricing of consumer goods, but the allocation of financial capital among the various branches of industry. By focusing on production and pricing decisions within a *given* structure of capital, the socialists ignore the vital role of capital markets.

## Toward an Austrian Theory of Corporate Governance

Given that financial-market entrepreneurship is the defining feature of a market economy, that economic calculation is the capitalist-entrepreneur's primary tool, and that economic calculation requires well-functioning capital markets, what can capitalist-entrepreneurs do to govern their relationships with operational managers? What should be the basis of an Austrian theory of corporate governance? This section suggests four areas that Austrians should address: (1) the concept of the firm as an investment; (2) the relationship between internal and external capital markets; (3) comparative corporate governance; and (4) financiers as entrepreneurs. Consider each in turn.

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[15] Compare Rothbard (1962, p. 538):

> Hired managers may successfully direct production or choose production processes. But the ultimate responsibility and control of production rests inevitably with the *owner,* with the businessman whose property the product is until it is sold. It is the owners who make the decision concerning how much capital to invest and in what particular processes. And particularly, it is the *owners* who must choose the managers. The ultimate decisions concerning the use of their property and the choice of the men to manage it must therefore be made by the owners and by no one else.

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*Firms as Investments*

Because the owner, and not the manager, is the ultimate decisionmaker, the Austrian theory of the firm should comprise two elements: a theory of investment (corporate finance), and a theory of how investors provide incentives for managers to use these resources efficiently (corporate governance). In microeconomics textbooks, by contrast, what the capital investors give to the firm is treated as just another factor of production. Its price, the "rental price of capital" or interest, is simply another cost to the producer. Any excess of revenues over costs, including the cost of capital, goes to the manager (sometimes confusingly called the "entrepreneur"). This residual is called "profit," though it is not profit in the Misesian sense.

In the ownership perspective, as developed by Gabor and Pearce (1952, 1958), Vickers (1970, 1987), Moroney (1972), and others, the firm is viewed as an *investment*. The firm's goal is to maximize the return on invested capital. This money capital may be regarded as a factor of production, but it is a unique factor, the "controlling" factor that receives the net proceeds of the operation. Other factors, such as labor (including management) and physical capital, are regarded as "contracting" factors that receive a fixed payment. The services of the top-level manager are thus treated as a cost, while the investor is considered the residual claimant. Also note that because the capitalist bears the risk that the investment will fail, upon investing the capitalist has become an entrepreneur. Furthermore, to the extent that the entrepreneur (as Kirznerian discoverer) hires himself out to the capitalist as a salaried manager, his compensation is not entrepreneurial profit; it is a cost to the owner of the firm (Rothbard 1985, p. 283).This has significant implications for firm behavior. First, the firm will not always expand output to the point where marginal revenue equals marginal cost. For if the firm is earning positive net returns at its current level of output, instead of increasing output until marginal net returns fall to zero, the firm could simply take those returns and employ them elsewhere, either to set up a new firm in the same industry or to diversify into a new industry (Gabor and Pearce 1952, p. 253). The efficient scale of production is determined by outside investment opportunities, not simply the marginal returns from producing a single output.

Indeed, it is easy to show that under fairly weak assumptions, the output level that maximizes the profit *rate* is less than the output level that maximizes the *level* of profit. Consider a standard, concave profit function; add a "money capital requirement," the amount of capital required to finance a given level of output. As long as the money capital requirement is increasing in output, the output level that maximizes the profit rate—profit divided by the money capital required to finance that output level—is less than the output level that maximizes profit. From the capitalist's perspective, output should be expanded to the point where the return on the last dollar of money capital is just equal to the opportunity cost of that last dollar of money capital. But as long as the plant manager is not free to invest his financial capital elsewhere, the manager's cost curves do not reflect this opportunity cost. Hence, the manager chooses a higher output level than that which maximizes the capitalist's return.

Significantly, for internal accounting purposes, firms are typically structured such that the goal of any operating unit is to maximize the return on its invested capital. In fact, not only do firms set up divisions as profit centers, as discussed above, but groups of profit centers are frequently grouped together as "investment

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centers" within the firm itself. Reece and Cool (1978) studied 620 of the largest U.S. firms in 1978 and found that seventy-four percent had investment centers. These subunits are commonly evaluated according to a return-on-investment (ROI) criterion, such as the ratio of accounting net income generated by the investment center divided by total assets invested in the investment center. More recently, measures such as residual income and "economic value added" (EVA) have become popular as an alternative to ROI (Stern, Stewart, and Chew 1995). The point is that individual divisions are being evaluated on the same basis as the corporation itself—namely, what kind of return is being generated on the financial resources invested.

Second, the firm-as-investment concept relates closely to an emerging literature on merger as a form of firm-level investment (Bittlingmayer 1996; Andrade and Stafford 1997). Once managers have acquired financial resources from capitalists, these managers have some discretion over how to invest those resources. To supplement the "normal" forms of firm-level investment—capital expenditures and R&D—managers may choose to purchase assets of existing firms through merger. Merger may be a different form of investment; Andrade and Stafford (1997) find, for example, that mergers in particular industries tend to be clustered over time, while rankings of non-merger forms of investment by industry tend to remain constant. This suggests that merger activity is encouraged by specific industry or policy shocks, like deregulation, the emergence of junk-bond financing, and increased foreign competition (Mitchell and Mulherin 1996). Nonetheless, mergers will be evaluated by the returns they generate, just like any other investment.

*Internal Capital Markets*

In his extension of the Coasian framework, Williamson (1975, 1981) describes the modern multidivisional or "M-form" corporation as a means of intra-firm capital allocation. Capital markets allocate resources between stand alone, single-product firms. In the diversified, multidivisional firm, by contrast, resources are allocated internally, as the entrepreneur distributes funds among profit-center divisions. This "internal capital market" replicates the allocative and disciplinary roles of the financial markets, shifting resources toward more profitable lines of production.[16] Coase claimed that firms "supplant" markets when the transaction costs of market exchange exceed those of internal production. Williamson adds

[16]Such a process is described explicitly in the 1977 *Annual Report* of Fuqua Industries, a diversified firm with interests in lawn and garden equipment, sports and recreation, entertainment, photofinishing, transportation, housing, and food and beverages:

> Fuqua's strategy is to allocate resources into business segments having prospects of the highest return on investment and to extract resources from areas where the future return on investment does not meet our ongoing requirements. . . . The same principle of expanding areas of high return and shrinking areas of low return is constantly extended to product lines and markets within individual Fuqua operations. Only with a diversified business structure is the application of this modern fundamental business investment policy practical.

Another highly diversified firm, Bangor Punta Corporation, explains that the role of its corporate headquarters is "to act as a central bank supplying operating units with working capital and capital funds" (1966 *Annual Report*).

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that diversified, multidivisional firms "supplant" capital markets when the costs of external finance exceed those of internal resource allocation.

According to the internal capital markets theory, diversified firms arise when *limits in the capital market permit internal management to allocate and manage* funds more efficiently than the external capital market. These efficiencies may come from several sources. First, the central headquarters of the firm (HQ) typically has access to information unavailable to external parties, which it extracts through its own internal auditing and reporting procedures (Williamson 1975, pp. 145–47).[17] Second, managers inside the firm may also be more willing to reveal information to HQ than to outsiders, since revealing the same information to the capital market would also reveal it to rival firms, potentially hurting the firm's competitive position. Third, HQ can also intervene selectively, making marginal changes to divisional operating procedures, whereas the external market can discipline a division only by raising or lowering the share price of the entire firm. Fourth, HQ has residual rights of control that providers of outside finance do not have, making it easier to redeploy the assets of poorly performing divisions (Gertner, Scharfstein, and Stein 1994). More generally, these control rights allow HQ to add value by engaging in "winner picking" among competing projects when credit to the firm as a whole is constrained (Stein 1997). Fifth, the internal capital market may react more "rationally" to new information: those who dispense the funds need only take into account their own expectations about the returns to a particular investment, and not their expectations about other investors' expectations. Hence there would be no speculative bubbles or waves.

Bhide (1990) uses the internal capital markets framework to explain both the conglomerate merger wave of the 1960s and the divestitures of the 1980s, regarding these developments as responses to changes in the relative efficiencies of internal and external finance. For instance, corporate refocusing can be explained as a consequence of the rise of takeover by tender offer rather than proxy contest, the emergence of new financial techniques and instruments like leveraged buyouts and high-yield bonds, and the appearance of takeover and breakup specialists, like Kohlberg Kravis Roberts, which themselves performed many functions of the conglomerate HQ (Williamson 1992). Furthermore, the emergence of the conglomerate in the 1960s can itself be traced to the emergence of the M-form corporation. Because the multidivisional structure treats business units as semi-independent profit or investment centers, it is much easier for an M-form corporation to expand via acquisition than it is for the older unitary structure. New acquisitions can be integrated smoothly when they can preserve much of their internal structure and retain control over day-to-day operations. In this sense, the conglomerate could emerge only after the multidivisional structure had been diffused widely throughout the corporate sector.

Internal capital market advantages, then, explain why diversification can increase the value of the firm. During the 1960s, entrepreneurs took advantage of financial-market imperfections (many due to regulatory interference) to form large, highly diversified firms (Hubbard and Palia 1999; Klein 1998b). They also benefited from

[17] Myers and Majluf (1984) show that if the information asymmetry between a stand-alone firm and potential outside investors is large enough, the firm may forego investments with positive net present value rather than issue risky securities to finance them.

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government spending in high-technology and other defense-related businesses, which were particularly suited for acquisition. In the two subsequent decades, financial-market performance improved, reducing the internal capital market advantages of conglomerate firms.

If entrepreneurs have a special ability to manage information and allocate financial resources within the firm—if diversified firms "supplant" external capital markets—then why are capital markets necessary at all? Why not, to paraphrase Coase's (1937, pp. 42–43) second question, organize the entire economy as one giant conglomerate? The answer is that the argument for internal capital market advantages does not "scale up"; it applies only to firms that are themselves engaged in rivalrous competition. This situation, in turn, implies strict limits to firm size, even for large conglomerates.

The argument for the efficiency of internal capital markets is that compared with outside investors, the entrepreneur can extract *additional* information about divisional requirements and performance. It is not that the entrepreneur's knowledge *substitutes* for the knowledge embodied in market prices. To evaluate the merit of a proposed investment, the central management of a diversified conglomerate still relies on market prices to calculate expected (money) benefits and cost. Internal accounting does not substitute for money prices; it merely uses the information contained in prices in a particular way. When capital-goods prices are distorted—for example, because of financial market regulation—then the entrepreneur's additional knowledge is that much more valuable. So under those conditions we would expect an increase in M-form corporations, allocating resources via internal capital markets. During the 1960s, that is exactly what we observed.

Correctly understood, the internal capital markets hypothesis does not state that internal capital markets *supplant* financial markets. It states that internal capital markets *supplement* financial markets. Even ITT's Harold Geneen, LTV's James Ling, Litton's "Tex" Thornton, and the other conglomerators of the 1960s were constrained by the need for economic calculation in terms of money prices. Thornton's "Whiz Kids" have been criticized for their advocacy of "scientific management" or "management by the numbers." Yet Thornton's techniques were quite successful at Litton. It was only when his disciple Robert McNamara tried to apply the same techniques to a nonmarket setting—the Vietnam War—that the limitations of "scientific management" were revealed.[18]

*Comparative Corporate Governance*

How well do various systems of corporate governance function? The last few years have seen the growth of a new literature on "comparative corporate governance," the study of alternative means of governing relations between firm owners and managers. The typical comparison is between stock-market systems like those in the U.S. and U.K., and bank-centered systems like those in Germany and Japan (Roe 1994, 1998; Gilson and Black 1997; Milhaupt 1997). According to Roe, the phenomenon he calls "strong managers, weak owners" is an outgrowth not of the market process, but of legal restrictions on firm ownership and control. In the U.S., for example, banks and other institutions are forbidden from owning firms; antitrust laws

[18]For more on the relationship between Thornton and McNamara, see Shapley (1993), and Byrne (1993).

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prohibit industrial combinations like the Japanese *keiretsu;* and anti-takeover restrictions dilute the effects of the takeover mechanism. Laws that require diffuse ownership create what Roe terms the "Berle-Means corporation," in which "fragmented ownership shifts power in the firm to managers" (p. 93).

Mises makes a very similar argument in *Human Action.* There he notes that "the emergence of an omnipotent managerial class is not a phenomenon of the unhampered market economy," but a result of government policy (Mises 1949, p. 307). Here he expands upon his earlier analysis in *Bureaucracy* (1944, p. 12), where he attacks the claim that bureaucracy follows naturally from firm size. Mises conceives of bureaucracy as rule-following, as opposed to profit-seeking, behavior. He reserves the term "bureaucratic management" for the governing of activities that have no cash value on the market. As long as a firm's inputs and outputs are bought and sold, the central management of the firm will have the information provided by market prices to evaluate the efficiency of the various branches and divisions within the firm. Then subordinate managers can be given wide discretion to make daily operational decisions without the pursuit of profit.[19] If an organization produces a good or service that has no market price—the output of a government agency, for example—then subordinate managers must be given specific instructions for how to perform their tasks.

The fact that managers in a private firm have latitude to make day-to-day decisions, Mises argues, does not make the firm "bureaucratic." "[N]o profit-seeking enterprise, no matter how large, is liable to become bureaucratic provided the hands of its management are not tied by government interference. The trend toward bureaucratic rigidity is not inherent in the evolution of business. It is an outcome of government meddling with business" (Mises 1944, p. 12). By this Mises means that government interference impedes the entrepreneur's use of economic calculation and the attempt to use prices to impose managerial discipline. Mises gives three examples (pp. 64–73): taxes and price regulations that interfere with corporate profits (distorting an important signal of managerial performance); laws that interfere with hiring and promotion (including the need to hire public relations staffs and legal and accounting personnel to comply with government reporting requirements); and the omnipresent threat of arbitrary antitrust or regulatory activity, in response to which entrepreneurs must become adept at "diplomacy and bribery" (p. 72). The effect of legal restrictions on corporate governance and organizational form is an important and growing area, and further research from an Austrian perspective is sorely needed.

*Financiers as Entrepreneurs*

As discussed above, the market for corporate control places strict limits on the ability of managers to pursue their own goals rather than those of the capitalist-entrepreneurs. However, in the mainstream literature at least, there is much debate

[19]Chapter 1 of *Bureaucracy,* on profit management and the sources of entrepreneurial profit, contains a remarkably lucid account of economic calculation under capitalism and its impossibility under socialism. "To the entrepreneur of capitalist society a factor of production through its price sends out a warning: Don't touch me, I am earmarked for another, more urgent need. But under socialism these factors of production are mute" (Mises 1944, p. 29).

Mises also provides a very Coase-like discussion of the make-or-buy decision, though without citation (p. 33).

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about the effectiveness of the takeover mechanism in providing managerial discipline.[20] If managers desire acquisitions to increase their own prestige or span of control—to engage in "empire building"—then an unregulated market will generate too many takeovers. Indeed, several studies have found a sharp divergence between market participants' pre-merger expectations about the post-merger performance of merging firms, and the firms' actual performance rates. Ravenscraft and Scherer's (1987) large-scale study of manufacturing firms, for example, found that while the share prices of merging firms did on average rise with the announcement of the proposed restructuring, post-merger profit rates were unimpressive. They find that nearly one-third of all acquisitions during the 1960s and 1970s were eventually divested. Ravenscraft and Scherer conclude that mergers typically promote empire building rather than efficiency, and they support increased restrictions on takeover activity. Jensen (1986, 1993) suggests changes in the tax code to favor dividends and share repurchases over direct reinvestment, thus limiting managers' ability to channel free cash flow into unproductive acquisitions.

However, the fact that some mergers—indeed, many mergers, takeovers, and reorganizations—turn out to be unprofitable does not imply market failure or necessarily prescribe any policy response. Errors will always be made in a world of uncertainty. Even the financial markets, which aggregate the collective wisdom of the capitalist-entrepreneurs, will sometimes make the wrong judgment on a particular business transaction. Sometimes the market will reward, *ex ante*, a proposed restructuring that has no efficiency rationale. But this is due not to capital market failure, but to imperfect knowledge. Final judgments about success and failure can be made only *ex post*, as the market process plays itself out. Moreover, there is no reason to believe that courts or regulatory authorities can make better judgments than the financial markets. The decisions of courts and government agencies will, in fact, tend to be far worse: unlike market participants, judges and bureaucrats pursue a variety of private agendas, unrelated to economic efficiency. Furthermore, the market is quick to penalize error as it is discovered; no hearings, committees, or fact-finding commissions are required. In short, that firms often fail is surprising only to those committed to textbook models of competition in which the very notion of "failure" is defined away.

Another criticism of the market for corporate control is that unregulated financial markets engage in too few takeovers, due to a free-rider problem associated with tender offers (see, for example, Scharfstein 1988). Critics point out that if the difference between the current (undervalued) price of the firm and its after-takeover market value is common knowledge, then the target firm's shareholders will refuse to tender their shares until the current price is bid up, appropriating a share of the returns to the acquiring firm. These critics conclude that regulation, not the takeover market, should be used to discipline managers.

The flaw in this argument is that it assumes perfect knowledge on the part of investors. The typical shareholder will *not* usually have the same information as incumbent managers, outside "raiders," and other specialists. It is not in the small shareholder's interest to learn these details; that is why he delegates such responsibilities

[20]For overviews of this literature see Romano (1992), Shleifer and Vishny (1997), and Zingales (1998).

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to the managers in the first place. As Hayek (1945) described it, there is a "division of knowledge" in society. The raider who discovers a difference between a firm's current market value and its potential value under new management has an opportunity for an entrepreneurial profit (less the transaction costs of takeover). Because shareholders have delegated these responsibilities, they will not usually earn a share of this profit. Nonetheless, as Rothbard (1962, p. 372) observes, because shareholders (owners) *choose* to delegate operational responsibility to managers—contracting out for the managerial function—they themselves retain the ultimate rights of control.

Moreover, the post-takeover market value of the firm is uncertain; the raider's profit, if he is successful, is the reward for bearing this uncertainty. In this sense, the takeover artist is a Misesian capitalist-entrepreneur. This account, however, could use further elaboration. For example, how is the bearing of uncertainty distributed among participants in various forms of restructuring? How do regulatory barriers hamper the capitalist-entrepreneur's ability to exercise the entrepreneurial function in this context?

## CONCLUSIONS

The main message of this article is that Austrians can continue to work within the contractual, or Coasian, approach to the firm in elaborating the insights discussed above. In particular, the problem of corporate governance, and the corollary view that firms are investments, belongs at the forefront of Austrian research on the theory of the firm. Emphasis should thus be placed on the plans and actions of the capitalist-entrepreneur.

A particularly undeveloped area concerns the provision of capital to small, "entrepreneurial" ventures. Most of the literature on governance focuses on the large corporation, and the use of stock and bond markets to govern these organizations. Equally important, however, are smaller, privately held firms, financed with venture capital or other forms of investment. So far, the firm-as-investment literature has said little about these organizations, despite their growing importance, particularly in high-growth, technologically-advanced industries like software and biotechnology. Further research in this area is sorely needed.

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# A BETTER RED: THE TRANSITION FROM COMMUNISM TO COCA-COLA IN ROMANIA

FRANK HEFNER AND DOUGLAS WOODWARD

The transition from central planning to market-oriented economies in Eastern and Central Europe provides a fascinating laboratory for research in economic theory and business practice. With the collapse of communism, the inefficiencies of centralized planning have been laid bare. The classic debates between Mises and Lange on the viability of planning, although long resolved in the minds of free-market advocates, have been settled. Poznanski (1992), in an aptly titled book, *Constructing Capitalism,* makes the following observation: "The experience of state socialist economies also validates the hypothesis that efficient production is not only impossible without market competition but also without private property as a principle form of resource ownership and use control." Austrian economists and others recognize that privatization of state-owned enterprises and the establishment of a system of property rights are the most important issues in the transition process. Svejnar (1991), for example, states that the absence of property rights is "the Achilles heel of the transition." Although economists such as Jeffrey Sachs and others, who have served as advisors to various governments in the transition, recognize that privatization is important, they, however, also add other issues such as fiscal reform (i.e., taxes), monetary stability, and so on. Rothbard (1992) has provided some insight into an Austrian perspective dealing with these issues. Problems dealing with privatization, monetary reforms, and so forth are macro issues. Our research has focused more on what we call the micro issues; that is, managerial and entrepreneurial problems in the transition.

Among the many challenges confronting economies in transition is the promotion of entrepreneurship and successful business practices. Entrepreneurship involves the ability to predict how consumer demand will change and to find cost-efficient ways of supplying new products that govern business success. Exercising this ability and developing the talent necessary for successful market ventures was foreign to Romanians under the old regime. Responding to consumer demand was impossible in the planned economies. To some extent, the mind-set that existed during the communist era remained intact after the collapse of the dictatorship and the liberalization of the economy. Arzeni (1996) contends

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that the entrepreneurial culture needs to be rediscovered and reinvented. Entrepreneurship is a natural outgrowth of human action. However, the people of Eastern and Central Europe have experienced forty years of rationing, shortages, and other forms of coercion imposed upon them by their governments. How businesses grow and develop out of an economic experience that has been characterized by government distortions is the fascinating transformation taking place in the economies of transition. Although Austrian economists are among the few that recognized the crucial role played by entrepreneurs, Austrian theory is silent on the mechanics of how entrepreneurs get started. To some extent, Austrians can rely on entrepreneurs springing forth spontaneously since profit seeking is a natural and normal action. Once the shackles of oppression have been removed, the entrepreneurial spirit will rise. The innovativeness of entrepreneurship lies in the ability of some new businesses to read the market better than others do—not simply in the short run as arbitrageurs, but in the longer term as fillers of innovative niches. The transition in Romania represents a unique opportunity to investigate the process of developing businesses and entrepreneurship from the remains of one of the most oppressive regimes in Central and Eastern Europe.

Our focus here is on the effects foreign direct investment (FDI) has had on the transformation process. FDI represents a desirable form of capital infusion—one seeking profits and exploiting market potential as opposed to a World Bank type loan or subsidies in the form of foreign aid. We were presented with a unique opportunity to investigate the effects of one multinational company (MNC), namely Coca-Cola, on the transformation process in Romania. We conducted interviews and surveys in Romania between July 1994 and January 1995. It seemed appropriate that a consumer product would be influential in the transition from a command to a consumer-led economy. As Austrian theory recognizes, production is only useful when it satisfies the desires of consumers. Foreign direct investment has often been castigated in the past, with expressions such as "Yankee imperialism." However, it is more appropriate to view FDI as a "white knight." We found that besides providing capital, FDI provides qualitative impacts in transferring entrepreneurial and managerial skills from well-established profitable firms to developing businesses in transitional economies.

## AN OVERVIEW OF THE COCA-COLA SYSTEM IN ROMANIA

As background, first consider the transition under way in Romania. In the tumult following the 1989 revolution, the country faced an uncertain and uncharted future. At least since Vlad the Impaler in the fifteenth century, Romania has been considered one of the more tormented parts of Europe. Recent history confirmed this role, for the political and economic difficulties facing Romanians stand out even amid the wreckage of former communist countries. Nowhere was a country so thoroughly exhausted after forty-two years as a "people's republic."

The terror, megalomania, and cult of personality that characterized Nicolae Ceausescu's regime since the early 1960s left the country completely unprepared for the transition to capitalism. Ceausescu's erratic and ultimately disastrous economic policies culminated in a desperate export drive during the 1980s that left the country with little foreign debt, but still woefully inefficient. With minimal exposure to the West through travel or business, Romanians had little foundation or experience with building consumer-oriented businesses within a market framework.

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Given the weak market and lack of a well-developed plan for economic reform, Romania posed large risks for foreign investors like Coca-Cola. Transition economies by their nature pose large risks because of the uncertainties of the market reform process. At the time of Coca-Cola's entrance, Romania had passed a Foreign Investment Law (1991). Coca-Cola received no special incentives to invest, but did receive the benefits already passed in the Foreign Investment Law. This law really did not provide incentives as much as it removed some of the disincentives, such as exemptions from customs duties for imported machinery. Raw materials, consumables, spare parts, and other supplies were exempted from import duties for a period of two years. Foreign firms were exempt from the payment of taxes on profits for a period of five years. At the time of Coca-Cola's first investment, foreign entities were not allowed to own real estate. Coca-Cola was able to operate in one case by signing a ninety-nine-year concession with the city administration, and in other cases by forming joint ventures with Romanian firms. The access of private companies to foreign exchange was established in 1991. Other than the few tax abatements mentioned, however, Coca-Cola did not receive any kind of governmental incentives. Romania at the time did not impose any wage or price controls for private companies. Coca-Cola did agree to a limited layoff policy for two years in the case of one of its joint ventures.

Since the Romanian people (except the ruling elite) had practically no access to Western consumer goods during the Communist era, Coca-Cola had to establish its image as one of the country's first differentiated, branded consumer goods (as opposed to faceless state products). No doubt, the trademark was already strongly identified with Western capitalism. Under the communist regime, Coca-Cola, like private consumer goods in general, was portrayed as an icon of Western decadence. To take just one bizarre example from the dark days of the Cold War, Coca-Cola was labelled "the beverage of capitalist sports" according to an official Romanian book on physical education. This was sometimes taken to an extreme, as in the 1959 case of a Romanian fencing champion jailed by authorities after he was caught drinking Coca-Cola in Krakow, Poland. The state forced him to sign a Kafkaesque confession indicating that the soft drink gave him hallucinations and stomach aches. In reality, this had little, if no effect on Coca-Cola's brand image in Romania. Bombarded with a myriad of propagandistic slogans, while facing a reality showing the contrary, Romanian people now say they gave little credence to the communist regime's attempts to indoctrinate them about the evils of capitalism, even after forty years.

Like most multinational companies, Coca-Cola never seriously considered expanding into Romania before the 1989 revolution. Unlike most Western companies, however, Coca-Cola saw the market potential early in the transition; it started planning to invest soon after Ceausescu's fall. At the time of the revolution, the soft drink market was dominated by poor quality state brands (B-brands) and Pepsi, operated under an arrangement in which state-owned enterprises were provided concentrate to bottle independently. Using low quality local sugar, water, glass, and other inputs, soft drink products were far inferior at least by Western standards. Predictably, the erstwhile lack of competition had ensured general incompetence.

Once the communist regime fell, Coca-Cola executives recognized a "new paradigm in Central and Eastern Europe" at a time when few other Western

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companies were willing to invest. The reason is that Coca-Cola is aggressively market-driven; its pursuit of markets has made it the most pervasively branded product in the world. In any event, Coca-Cola was the largest foreign investor in Romania after two years into the transition. Everywhere, its red-and-white logo symbolized the rebirth of capitalism, as it had elsewhere. In newly emerging market economies like Romania, Coca-Cola quickly went from contraband to status symbol. The appearance of Coca-Cola trucks on bleak, riot-torn Bucharest streets was welcomed by citizens weary from years of deprivation and unaccustomed to consumer goods of any consistent availability or quality.

Thus, Coca-Cola became a highly conspicuous consumer good in the early period of the Romanian transition—available throughout the country and just as widely accepted. However, it was not an "invisible hand" that brought the product to the people; it took real individual risk and effort to rebuild the exchange system. Nevertheless, throughout Romania's cities, villages, and towns the "fingers of the invisible hand" (Clower 1994) soon reappeared.

Thus, when the old regime collapsed in late 1989, thousands of small shops and street vendors sprang up around the country. The essence of free enterprise, these kiosks and other small-scale retail outlets played a pivotal role during the turbulent first years into the market transition. Under communism, only decrepit state-owned stores were permitted in Romania. There was no Hungarian "goulash" system , the kind that allowed for limited private enterprise along with statism. But when allowed to form, markets appeared almost instantaneously. At first, the re-emergence of retail trade in Romania was dominated by makeshift operations with no focus on what to sell. For many of these *nouveaux* entrepreneurs, Coca-Cola provided that focus in the early years of transition, especially for the small retail shops and kiosks. In the early 1990s, a large part of the livelihood of these micro businesses came from high turnover products like soft drinks and cigarettes. The profit from these sales then became capital to pay for inventory and for the rest of the operational expenses and for expansion. Romania's burgeoning retail sector, its new "petite bourgeoisie," used Coca-Cola as a main source of cash flow.

Coca-Cola products served as a magnet for the kiosks, with cases piled outside used as advertising. In an ironic twist, the grey facade of communism was literally covered with Coca-Cola's red-and-white signs within twenty-four months of Ceausescu's downfall. Conditioned by the shortages that existed in the previous regime, the regular availability of consumer products was considered somewhat miraculous by Romanians. The small retailers and traders found that simply providing an indication that they stocked Coca-Cola products drew customers to their shops. For many Romanian entrepreneurs, Coca-Cola provided the direct link to modern business practices.

## THE IMPACT OF COCA-COLA ON ROMANIAN BUSINESS

As the familiar Coca-Cola logo spread throughout Romania, it signified the renaissance of the Romanian market economy. By 1994, tens of thousands of businesses were distributing and selling Coca-Cola products. Many other businesses supplied inputs for soft-drink production. These linkages created and supported employment as the state sector shrank.

What are the effects of investment by a market-driven multinational company on local business in a transition to markets? Besides its visible impact on re-establishing

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retail trade in the country, Coca-Cola's investment affected many other areas of commerce. Given Coca-Cola's status as an early entrant in the market economy, it served as the vanguard of the private sector in many areas. One significant transformation in the Romanian business sector propelled by Coca-Cola occurred in advertising. According to some business leaders, the modern advertising industry began in Romania with Coca-Cola's entrance. Known worldwide for sophisticated, high-quality, and highly successful advertising techniques, Coca-Cola brought these techniques to Romania, insisting on comparable quality being provided by Romanian advertising firms. If it was not available locally, it was imported from other firms. Coca-Cola's superior quality commercials quickly set the standard of excellence for the country, winning national competitions and putting considerable pressure on other manufacturers and advertising companies to upgrade their efforts. The same effects occurred with outdoor and radio advertising.

Another competitive effect of the company's investment was an upgrading of product quality. Coca-Cola's insistence on quality spread through its linkages with other sectors of the economy. It would be hard to overstate the importance of introducing quality into a transitional economy. Coca-Cola had a policy of localizing as much of the inputs as possible in order to reduce costs. Yet, it also had a policy of strict quality control. The two policies often clashed in transitional economies. The state-owned industries were not accustomed to delivering quality goods for the internal Romanian market, and the central planning system of the previous regime paid little attention to quality. As a result, the notion of customer satisfaction or product quality were foreign to state-owned enterprises. Even newly-formed or privatized businesses found these concepts to be alien to their mode of thinking. As one U.S. manager stated, "How do you communicate the importance of one-hundred percent quality to people who have been accustomed to standing in line and buying whatever is available at whatever quality?" (Fogel 1995). This manager found that retooling factories is easier than retooling attitudes. While it was common for businesses in developed market-oriented economies to switch suppliers if they were not satisfied with product delivery, this notion was foreign to the practices found in Romania at the time.

Many of the qualitative effects of Coca-Cola on the host economy can be summarized as technological, managerial, and organizational competencies. Coca-Cola brought experience to Romania. Specifically, Coca-Cola brought distribution expertise and the concept of serving the customer, which was foreign to the state-owned Romanian enterprises. Coca-Cola provided the first example of a corporate culture in Romania. For example, the manager of a private printing company with Coca-Cola label contracts found that FDI like Coca-Cola's had already been beneficial for Romania by stimulating efficiency through technology. Whereas a privately-owned company used thirty-six workers to produce seventy-five percent of the orders for Coca-Cola labels during 1994, its state-owned competitor used forty workers to produce twenty-five percent of Coca-Cola's label business. The state company used the same label machines as the private printer but three times the number of operators. When packing the labels, five times as many workers were used. Although employment declined in the more efficient private label maker, salaries doubled.

Rondinelli (1994) noted that in the old regime the socialist leaders pushed state enterprises to create jobs and made it difficult to terminate employment. As a

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result, managers had no incentive to use workers efficiently. At the same time, workers were not motivated to be productive: their jobs were secure, their pay was low, and a large portion of their consumption came from state subsidies. The prevailing attitude of workers toward management was reflected in the aphorism: "I'll pretend to work and you pretend to pay me." The idea that labor should be a variable input was completely foreign in the old regime. Coca-Cola plant managers reported in interviews that getting the concept across that labor should be a variable input was very difficult. We observed a similar phenomenon in interviews with Polish managers of privatized plants (Hefner and Woodward 1997).

In many respects, Coca-Cola set the standards for technological, managerial, and organizational competence throughout the country. As a major MNC in the early transition period, its demonstrative effect was crucial. Other companies, local and foreign, sought Coca-Cola's trained personnel.

Coca-Cola's presence led to greater competitiveness and product diversity in Romania through a number of avenues. Being a supplier to Coca-Cola put a stamp of approval on a company's ability to deliver a quality product. Several anecdotal reports confirmed that having Coca-Cola contracts stimulated additional business for some suppliers: the contract enhanced the reputation of the supplier. We surveyed six major suppliers in Romania, all of whom reported that working with Coca-Cola helped them establish other contracts. It was well-known that Coca-Cola demanded high quality and on-time-delivery. As a result, firms with Coca-Cola contracts received, in essence, a "stamp of approval" that signalled to other businesses that the supplier could deliver quality, on time.

## CONCLUSION

Private economic activity developed from nothing after 1989 with the fall of Ceausescu (Hunya 1992). Given the extreme isolation of the Romanian economy prior to 1989, it was not altogether surprising that Coca-Cola's investment had a large demonstration effect. The major effect of Coca-Cola operations on the economy came through the introduction of market-oriented, profit-motivated business practices. In the old economy, suppliers controlled the flow of activity. Bribes were sometimes required to get delivery and, even then, it was erratic. In the new economy, thousands of kiosk owners, the embryonic entrepreneurs of Romania, had the free service of a supplier (Coca-Cola) bringing its product to the point of sale. Regular and free delivery were radical concepts, bringing a permanent and reliable source of cash to the retail and wholesale sector that mushroomed after 1989. In essence, Coca-Cola became a mainstay of small business privatization and entrepreneurship in Romania. There was also significant impact of a symbolic nature resulting from Coca-Cola's presence in Romania.

Rothbard (1992) provided suggestions for successful desocialization. Herbener (1992) discussed the role of entrepreneurs in the process and noted that "Entrepreneurship has no direct role in bringing about the program of desocialization." However, entrepreneurship and, as we found, foreign direct investment illustrate the benefits of the market economy to a country steeped in planning and government distortions. We found that foreign direct investment can play a major role in the education process needed to retool the attitudes and business practices of Romanians during the transitional process.

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# THE HINDENBURG PROGRAM OF 1916: A CENTRAL EXPERIMENT IN WARTIME PLANNING

T. HUNT TOOLEY

It has long been recognized that the year 1916 was the turning point in World War I, the year in which, as historian René Albrecht-Carrié (1965) put it, the deeper forces broke through.[1] This process is not nearly as mysterious as it sounds on first hearing. On the battle fronts, the bloodlettings of 1916—Verdun, the Somme, Jutland, and the Brusilov Offensive—expended both lives and wealth at such a rate as to push an already relentless war to a whole new level of destruction and national expenditures. On the home fronts, not least among the costs of these massive battles—and perhaps of all the costs, the most fateful for the twentieth century—was the restructuring of the Western Front governments in such a way that they could extract more and more resources from their populations.

For Germany, fighting on two titanic fronts and against a coalition with resources far greater than those possessed by its own alliance, the year 1916 strained every muscle. The German army launched the Verdun offensive in February with the explicit purpose of bleeding France white and found itself bleeding as well. Moreover, from July until November, the Germans absorbed the powerful blows of the British and French in the Somme attack: though one more often discusses the colossal losses of the British in connection with the Somme, the Germans lost almost 420,000 men killed, wounded, or captured (a greater number than in the whole ten-month *abbatoir* at Verdun, where they lost *only* 337,000).

In all the belligerent countries, this terrible year of warfare effected farreaching changes, in fact veritable social crises, at home. It is clear that Western and Central European governments had been drifting toward interventionist economic structures since at least the 1870s, and that World War I accelerated this drift among all belligerents. Further, in all the belligerent countries, the social crisis of 1916 resulted in the very rapid extension of the "command" measures of economics

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[1] See especially Hayes (1941).

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and politics toward which those governments had been working since 1914, and to some extent during the forty years before the war.[2]

In the German case, this move to the full-fledged command economy, embodied in the Hindenburg Program of August 1916, represents the kind of sudden, crisis-generated growth in the size and appetites of government which Robert Higgs examined (in the case of the United States) in his *Crisis and Leviathan* (1987, chap. 7; 1999). It is clear that the "deeper forces" of modern war and industrial aggregates were at play in the case of the Hindenburg Program and that, as in all the other belligerent economies, the 1916 measures intensified the German wartime economic and social controls which had been introduced from the beginning of the war. Yet, it is likewise clear from the mechanics of the Hindenburg Program that these fundamental changes in modes of government and economy owed as much to human—indeed individual—agency as to the gigantic forces which had been brought into play. Clearly, a pre-existing central-planning mentality was fundamental to the creation of the total war state, as will be seen below.

It should not be surprising that one of the century's closest students of omnipotent government and the technocratic mentality, Ludwig von Mises, mentions the Hindenburg Plan in a number of passages as the quintessence of the command economy, or *Zwangswirtschaft*, in Germany during the World War I. In 1940, in the midst of furor for central planning in a later war, Mises pointed out the extent to which most political parties in interwar Europe had adopted important premises of the socialist program. "If the Hindenburg Program had been executed," he wrote in 1945, "it would have transformed Germany into a purely *totalitarian* commonwealth" (Mises 1974, pp. 25, 77).[3] As it happened, World War I was over before this plan took full effect, but the program—if abbreviated in its duration and somewhat limited in its effects—was disastrous for Germany and instructive for us. In this article, I intend to make two general points about this episode of centralized planning: one about about the genesis, or rather genealogy, of the program, and one about its effects.[4]

For all the aggressive talk of German diplomats and of the Kaiser in the years before 1914, Prussia-Germany—in common with all the other powers—gave little thought to planning for a lengthy war (Burchardt 1967). For one thing, general staff planners relied on their famous Schlieffen Plan as a rapid means of defeating both France and Russia. And indeed, most observers in Germany and everywhere else, assumed that the next war would be a short—if violent—one, since no existing state apparatus could marshal the enormous resources to fight a long war using modern industrial means, high technology (especially modern artillery), and the larger armies that could now—with better means of communication—be fielded.[5]

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[2]See especially Rothbard (1972, 1998). For the European context, a good place to start is the Introduction and useful collection of primary texts in Clough, Moodie, and Moodie (1968).

[3]For the broader context of interwar Austrian-School thinking about war planning, see Caldwell's excellent Introduction in Hayek (1997, pp. 5-19).

[4]For histories of the Hindenburg Program, see Feldman (1966), Mendelssohn-Bartholdy (1937), and Kitchen (1976).

[5]German experts predicted that future wars could only last from about six months to a year, see Burchardt (1967, pp. 14-50) and also Farrar (1973).

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On the other hand, the so-called "mixed" form in which German autarkic state socialism emerged during World War I had plenty of precedent in the history of Prussia, a state that had survived into the modern period through a combination of controlling and ransacking the economy and the promotion of an ideology of aristocratic collectivism. Various German states and Prussia in particular had experimented with economic liberalism in the nineteenth century, it is true, and unified Germany was for some time influenced by free-market thought.[6] But by the 1880s, Germany was expanding on the earlier Prussian heritage of "mixing" the economy by privileging various industries in various ways, setting up wide-ranging protectionist policies, assisting in the building of monopolies and cartels, and maintaining direct government ownership in parts or all of many enterprises. The whole program was bolstered by Adolf Wagner and other *Kathedersozialisten*, who promoted government coordination of all segments of society.[7]

Once the short war proved illusory—that is, after the failure of the Schlieffen Plan by October 1914—the German government found itself in a war which rapidly outran resources. Inflationary financing to transfer wealth to the government could go only so far in fighting a war on multiple fronts and on the high seas. Indeed, the sea-related problem of being cut off from imported goods (by the British navy) really pointed out what many military and civilian thinkers regarded as the two essential problems of the war economy: first, the need to achieve some kind of sufficiency within German borders, and second, the lack of a carefully planned economic regime analogous to the military planning of the general staff system.

Less than ten days after the war broke out, Walter Rathenau, industrialist and visionary author, met with the chief of the general staff, conveying the fears of one of his engineers—Wichard von Moellendorff—that metals would be in extremely short supply should the British set up a tight blockade. By August 9, Rathenau was head of a new War Raw Materials Office within the War Ministry, with Moellendorff as his assistant. Its function was to organize raw materials production for the war effort. Its influence on the shape of German war organization was tremendous and eventually reached far beyond the areas of industrial raw materials in both its direct and indirect influence. And though Rathenau resigned in March 1915, both he and Moellendorff proved influential at the highest levels not only throughout the war, but after the war in working to create the social-welfarist system of the Weimar Republic (Feldman 1966, pp. 45–50; Brecht 1966, pp. 272–74).

A brief look at these two planners is worthwhile.

Walter Rathenau, born in 1867, was the son of German industrialist Emil Rathenau, founder of the giant electrical company Allgemeine Elektrizitäts-Gesellschaft (AEG). Related in part to his experience in the cartelized German economy, and in part—as most of his biographers hold—to the secret shame of his Jewish

[6]Tilly (1966) demonstrates that Rhineland industrialization benefitted greatly from a nearly unintentional attitude of laissez-faire concerning currency and banks; in Hentschel (1975) and Raico (1999) one finds much material about the significant free-trade movement in Prussia and Germany, a movement which, however, was overpowered by the protectionism of the late 1870s.

[7]A good description of "Prussian Mercantilism" and state socialism before 1914 is in Bruck (1962, pp. 35–60).

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heritage, Walter Rathenau began to develop a romantic or mystical condemnation of "machine civilization," whose labor and distribution problems could be solved by the kind of monopolistic integration and central decisionmaking that he oversaw for a time as a board member at his father's company. Social Darwinist overtones were clear in several prewar books on the subject of what one might call the philosophy of the planned economy. In the decade before the war, he studiously associated himself with government officials and dollar-a-year type missions. Hence, when he presented himself to Field Marshal Falkenhayn a week after the war started, there was a certain logic in making the mystical technocrat Rathenau the head of industrial planning for war (Pachter 1982; Kessler 1930; Joll 1960).

Rathenau's most important assistant was Wichard von Moellendorff, an engineer in AEG. Of aristocratic background, he had become a disciple of the American efficiency expert Frederick Winslow Taylor, Social Darwinist and environmentalist planning guru.[8] Even before the war, Moellendorf hoped to control unruly individuals and prevent inefficient competition by erecting an autarkic state in which vertical and horizontal integration of industry, and its control by government overcame the selfish inefficiencies of individual choice. The war provided him the chance (Feldman 1966, pp. 46–47; Bruck 1962, pp. 136–41).

The planners were trying to reorient and reorder an economy under the gun. In summing up the work of the Raw Materials Office after its first year in existence, Rathenau claimed that the interventionist planning of the group had "no precedent in history" and would "in all probability is destined to affect future times." "Coercive measures" were, of course, necessary from the beginning, since the war effort would demand priority for supplies. Yet, the attachment of Germany to the rule of law was problematic to the planners: laws relating to economic and industrial life had hardly changed, Rathenau said, since the time of Frederick the Great.[9] This "defective and incomplete state of our laws," that is, presumably, those laws protecting the freedom and property of individuals, was remedied by a new regime in which old words were given new meaning:

> The term "sequestration" was given a new interpretation, somewhat arbitrarily I admit, but supported by certain passages in our martial law. . . . "Sequestration" [now] does not mean that merchandise or material is seized by the state, but only that it is restricted, i.e., that it no longer can be disposed of by the owner at will but must be reserved for a more important purpose. . . . At first many people found it difficult to adjust themselves to the new doctrine. (Rathenau 1932)

No doubt many did find this adjustment difficult. Yet, neither the Raw Materials Office nor various other economic planning units relied solely on simple "sequestration": indeed, the planners recruited many industrialists into boards to coordinate

[8]See Taylor (1967). Taylor deplored the "wastes of human effort" as it existed in his own "blundering, ill-directed, or inefficient" society. And he proposed extending his principles of scientific management to every sphere of life to achieve "national efficiency."

[9]Frederick the Great, for all his own statist economic enterprises, did in fact try to blend the old Prussian respect for law with the Enlightenment respect for the individual. The circulation of the story of "the Miller of Sans Souci"—a story in which the Miller stands up to the young king by pointing to the power of law—demonstrates something of this devotion, whether the story is apocryphal or not. Rathenau's reference to Frederick the Great here is quite specific.

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their own output and prices for the sake of the war effort. Cooperation was important for the producers, for over time, the state used its authority to starve small and medium industrial producers of both labor and raw materials and then to consolidate these plants into one of the great cartelized government-supported concerns. For example, one contemporary observer reported that thousands of local German electrical companies disappeared, to be incorporated into the "rationalized" fold of either AEG or the Siemens concern. Some branches of industry were "reduced" by half in order to "save" on labor and raw materials, according to historian Gerald Feldman: "Of the seventeen hundred cotton-spinning and -weaving plants operating before the war, only seventy 'high productivity' plants were functioning in 1918."[10]

In practice, of course, in spite of the efficiencies dreamed of by Rathenau and Moellendorff and their fellows, the results reflected instead the impossibilities of planning. Germany did produce enormous quantities of military goods during the war. And as central planners go, Rathenau—an experienced businessman—was more familiar with the realities of production and distribution than most of the long string of central planners in the twentieth century. But one must emphasize here the Austrian School point that expertise is hardly the point at issue, but rather the impossibility of the kind of calculation that takes place within the market, or that would have to take place as a substitute for the market. Rathenau was undoubtedly a brilliant "planner," but the war planning nonetheless resulted in a disastrous cost to society.

One spectacular case illustrating both the complexities and the cost of planning is the Pig Slaughter of 1915. Beginning in November 1914, the government had put in place price ceilings on potatoes, which made it more profitable for farmers to feed their potatoes to their hogs than to sell them, though the government also rapidly outlawed the foddering of potatoes. The inevitable potato shortages were immediate and severe. In the cities, outcries were raised, but against the farmers rather than the government. Soon, journalists and politicians were claiming that people and pigs were in a competition for the potatoes, and that some portion of Germany's twenty-seven million pigs must go. Beginning in March, the government therefore signed the death warrant of nine million pigs. It is hardly surprising that in this welter of planning and intervention, neither potatoes nor pork became more plentiful (Davis 1992; Lee 1975).

And yet the measures taken by the *central* government do not tell the whole of it. Local authorities from the federal state downward likewise partook in the planning hysteria. A collection of documents concerning food control in the Lichtenberg section of Berlin, assembled in 1916, contains 180 separate decrees, regulations, and ordinances, and these don't even include national directives from the real central planners. Item 82 ("Ordinance on the Regulation of Meat Consumption") gives something of the flavor of this collection. Apart from the basics of regulating meat sales, such as adjusting the definition of "fat" and limiting the relative amounts of meat on the bone and deboned meat that might be purchased, there were far greater intricacies, such as the control of the Meat Card, without

[10]Feldman's (1966) view of their work is fairly positive. A conservative observer writing from the vantage point of 1918, however, saw things a good deal differently; see Lambach (1918, pp. 20–32; a copy of this polemical booklet is in the "Krieg 1914" Collection of the Prussian State Library, Berlin). For the figures and quotation at the end of the paragraph, see Feldman (1993, pp. 78–80).

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which no one would get meat rations. Most of the people concerned lived in rented housing, and the Meat Card was carefully policed by the building owner (dragooned into the service of the state), with the help of the Building Executive Committee. To quote directly, "Should an occupant of the building die, or if he moves to another location, the Building Executive Committee has the duty of delivering the Meat Card formerly belonging to that building occupant immediately to the Nourishment and Grocery Section of the City Council" (Lebensmittelversorgung 1916). Such had become the fabric of life by 1916.

The Hindenburg Program itself was really the outgrowth of these efforts at Command Economy. The background was the intensification of the war in 1916, the result of the slaughters of Verdun and the Somme, and the subsequent replacement of the chief of the general staff, Erich von Falkenhayn, by the victors of the Eastern Front, Hindenburg and his lieutenant, Ludendorff. The explicit plan of Falkenhayn at Verdun had been to unleash attack after attack on the French with the objective of "bleeding the French white." German losses were, of course, likewise massive, and the level of artillery shells being fired off reached a new plateau. The British attack on the Somme as of July 1, 1916, drained German resources still more. The civilian and military leadership of Germany therefore faced a shortage of shells and before very long a shortage in productive capacity along a broad front of items to support the intensified war effort. Under these circumstances, at the end of August 1916, Falkenhayn was replaced.

Walter Goerlitz, historian of the German general staff, asserted that in essence Falkenhayn left command because he was unwilling or unprepared to effect a transformation of the economy from the "traditional profit economy" and the standing aspiration of workers for an "enhanced standard of life" (Goerlitz 1953, pp. 172–73). Falkenhayn was perhaps worried about revolutionizing the social structure of Germany, but it was nonetheless the case that the previous controls were already being discussed as "war socialism." Hence, one wonders whether Falkenhayn's departure resulted from his own scruples, from what was perceived as strategic failure at Verdun, or from what might at that time have been termed simply "lack of energy."

Certainly the ousting of Falkenhayn had been the object of a fairly diverse coalition comprising officers from the general staff, steel producers who objected to irregular methods of general staff planning, and politicians who wanted to bring Hindenburg to supreme command in order to cash in on his public image. Coordinating these efforts was an officer on Falkenhayn's staff, Colonel Max Bauer, who was already making plans for a "total war" regime well before Hindenburg and Ludendorff came to the rudder (Ritter 1972; Williamson 1971, pp. 172–73). Ludendorff had always been the workhorse and planner behind the successes of the famous team, and Bauer's long-range interest in harnessing the resources of Germany in a "total" fashion found echoes in Ludendorff's own opinions: Ludendorff had openly espoused the idea that instead of half-measures, the country ought to go on a total-war footing, to correspond with unlimited submarine warfare, and eventually total victory as opposed to negotiated peace.[11]

Yet in all probability, Colonel Bauer—who would be active in the Nazi Party at a later period—actually laid out the elements of what became the Hindenburg

[11] On Ludendorff's ideas, see Rosenberg (1962, pp. 123–37).

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Program. Bauer worked out his plan in conjunction with Moellendorff, with whom the general staff officer had come into contact through Fritz Haber, Nobel Laureate in Chemistry, introducer of poison gas to the battlefield, and later advocate of total government. Eventually General Wilhelm Groener, a technocratic general who in October 1916 was working as head of the army rail transport service and as a board member of the War Food Agency, was brought into the planning elite as head of a new *Kriegsamt*, or War Bureau, with coordinating powers over the whole economy (Ritter 1972, pp. 351–52). Soon, the planning elite was filled out with other industrialists, military men, and individuals from many parts of the political spectrum who cooperated in working out the coercive details of the Hindenburg Program (and some of whom would later assume the same role in Hitler's economic and strategic-planning apparatus after 1936). As Gerald Feldman has put it, Moellendorff viewed the whole program as "the institutional framework for a new economic order" (Feldman 1966, pp. 66–68; Stern 1987), and a variety of men seemed well up to the job of forming a new planning elite of very diverse origins.[12]

In any case, the program was launched almost immediately after Hindenburg and Ludendorff took over. With a distinct Stalinist air, but without outright expropriation of property, the Hindenburg Program called for large increases in heavy industrial output of weapons and ammunition, in some cases doubling, even tripling production. As a contemporary economist evaluated the plan, "the so-called Hindenburg Program claims the remainder of our goods production for the use of the state, at the same time that the new demands have made the increase and extension of our current production facilities necessary."[13]

In December, moreover, the planners pushed through an acquiescent parliament the Patriotic Auxiliary Service Law to make every German citizen from seventeen to fifty liable to involuntary wartime service. Justifying this measure, Bauer wrote in September 1916, "There are thousands of war widows who are only a burden on the government. Thousands of women and girls are either simply idle or pursuing unnecessary occupations." Trying to shore up labor shortages from other sources as well, Ludendorff oversaw the rounding up of tens of thousands of forced laborers from Belgium and northern France to work for the German war effort.[14] Some parts of the plan were never realized before the war ended: closing of universities, calling up all the weak and unfit so that they could heal at "suitable stations," compulsory labor for the whole population "more or less in conjunction with the distribution of food tickets." As Hindenburg wrote in September 1916, "The whole German nation must live only in the service of the fatherland."[15]

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[12]A very similar configuration of planners from diverse sectors—a good many of them actually the same individuals—worked together in a kind of economic planning elite under Hitler after the mid-thirties. Hermann Schmitz of I.G. Farbenindustrie, planner under both the Hindenburg Program and the 1936 Four Year Plan provides a study in this kind of continuity. See especially Carroll (1968), Petzina (1968) and Thomas (1966).

[13]Much of the official documentation is published and available in English in Ludendorff (1971). See also the contemporary analysis of Wiedenfeld (1918, p. 16).

[14]Hindenburg is quoted in Asprey (1991, pp. 284–86).

[15]See the proposals sent over Hindenburg's signature to Bethmann Hollweg, 13 September 1916, printed in Ludendorff (1971, pp. 77–81). The quotation comes from page 79.

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The results of this massive intensification of intervention into German society might have been predicted. The various increased output quotas led to a national railroad crisis in early 1917. Working conditions in factories worsened as hours lengthened. Accident rates shot up as lesser skilled workers were pushed into skilled jobs. Food supplies were already short as a result of the British Blockade, but an amazing array of substitute (*Ersatz*) products had up to now staved off starvation. Now, as more of the country's resources went into war production, food supplies dropped dramatically. Bad weather also produced a shorter than average growing season and hence a poor harvest. The first winter of the Hindenburg Program was remembered bitterly as the Turnip Winter: the allotment of food in Berlin consisted of between two and six pounds of turnips (or, if available, two pounds of bread), less than two ounces of butter, and one ounce of margarine, one of the many *Ersatz* products created by war shortages. Inadequate food supplies led to strikes in Berlin, the Ruhr, and other areas in early 1917. On top of the death and destruction prevailing at the front, the human misery of Germany under the Hindenburg Plan was enormous (Davis 1992, pp. 287–88; Feldman 1966, pp. 325–27).

Meanwhile, state-supported scientists held public lectures reassuring Germans that they were not really hungry. "Our nutrition," one such "scientist" put it at the end of the Turnip Winter during a lecture in Berlin, "is totally outstanding!" Indeed, the same lecturer pointed out all the advantages accruing to the German wartime diet. One could hear, the Professor allowed, that certain ignorant classes of the population were spreading rumors about starvation, but in reality, the newly efficient diet was not only plenty for even the heaviest work, but had contributed signally to the eradication of disease: "Certain diseases . . . have almost disappeared." This positive thinker and others went from lecture to seminar spreading the happy word about the health benefits of food planning. Teachers and pastors gathered for three-day meetings, after which they could spread abroad the good news about the newly engineered diet and pass along ideas about efficient cooking and new recipes (many of them including turnips) (Abderhalden 1917; Deleiter 1917).

Suffice it to say that the multifarious frictions of war and a worn-out, hungry home front made it impossible to implement all the points of the Hindenburg Program, even before the war ended in November 1918. Hence, the universities of Germany were never closed and ransacked to create labor battalions, and compulsory mobilization of women was never fully carried out. Still, the plan went far enough in the dislocation of the war-wrecked economy that it certainly prepared the way for the economic, political, and social chaos encountered by Germany's soldiers when they made their way back home.

Central planning is, of course, a kind of contradiction in terms. Mises, Hayek, and the Austrian-School economists since that time have pointed out again and again that only a free market is capable of producing anything like a systematic and accurate method of calculation for economic planning. Mises certainly allowed for warlike activity on the part of the state:

> The defense of a nation's security and civilization against aggression on the part of both foreign foes and domestic gangsters is the first duty of any government. . . . It is the government's business to make the provisions for war. (Mises 1962, p. 24)

But it is axiomatic that Mises—and the Austrians after him—considered war and the growth of government to go hand in hand. Governments have a natural proclivity

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to grow during war and the society must then alter its production profile in order to fight the war, especially a modern war. Once begun, there remains the question of whether the massive weapons of choice will really activate the necessary power-enhancing spiral desired. The Hindenburg Program illustrates that the war planning apparatus of the modern state tends to draw to it many individuals who hope to *use* war to change the system permanently.

An explanation by comparison may help here. The American collectivist philospher John Dewey, a contemporary of the Hindenburg Program elitists, plumped enthusiastically for American entry to the war. The war represented to him "a plastic juncture" in history, during which right-thinking leaders could mold the United States easily in the direction of "social possibilities," to remodel "the individualistic tradition," to make "instrumentalities for enforcing the public interest in all the agencies of production and exchange," to establish "the supremacy of public need over private possessions" (Kennedy 1980, pp. 50–51).

Any one of these phrases could have come from the pen of Rathenau or Moellendorff. It was indeed a team of elitist collectivists much like Dewey who did the wartime planning in Germany. Interestingly, before American entry into the war, another great American elitist and advocate of a new progressive order, Edward Mandell House, met Rathenau in the course of his negotiations. Highly impressed, House wrote to Wilson: "I met last night an able and sane man by the name of Dr. Rathenau. . . . He has a such a clear vision of the situation and such a prophetic forecast as to the future that I wonder how many there are in Germany that think like him" (Seymour 1926, vol. 1, p. 402–03). Like surely recognized like here, as the author of *Philip Dru: Administrator*[16] encountered a real soulmate.

The Hindenburg Program was a disaster for Germany and for the modern world. For Mises, the plan represented a decisive step by Western governments in the adoption of central planning without the unpopular "socialist" overtones of nationalization of the means of production. Most political parties in interwar Europe, Mises wrote in 1940, had adopted important elements of the socialist program, but "Their socialism was not that of Lenin who wanted to organize all industries along the lines of the government postal service. Their socialism was the command system of the Hindenburg Program of the latter part of World War I and the 'German' socialism of Hitler" (Mises 1978, p. 15). From the midst of intellectual battles against central planning and the command economy—battles fought principally by Mises and Hayek—a generation later, the Hindenburg Program proved both primal event and apt shorthand for the evils, wrong-headedness, and indeed inefficiencies of command economies whatever their remove from 1916, and even in peacetime.

Finally, there is perhaps a valuable lesson in the Hindenburg Program episode which has to do with the psychology of wartime planning and indeed central planning in general. From Saint-Simon to Comte to Marx to Dewey to Rathenau to Stalin, the argument of collectivism from the standpoint of "the good of the whole" has a less optimistic argument on the reverse side, this one from the standpoint of

[16]House authored a novel of this title in 1911, publishing it anonymously in 1912. The novel envisioned the introduction of a new, "progressive" constitution by means of the dictatorship of the novel's hero, Philip Dru. The resulting order resembled in many respects the kind of collectivist, technocratic decisionmaking advocated by Rathenau. See House (1912) and Seymour (1926, pp. 152–54).

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"the ignorance and incompetence of the whole." Those who want to plan the lives of others are operating from a psychology of superiority, of the technocratic elite, of the master race in some variant. It may be that this psychological tendency is prevalent among the personality types who end up in the top positions in all modern mass political systems. It certainly seems to be easier to advocate top-down control and justify it by verbiage about protecting the whole of society than it does to be a Jefferson, or a Bastiat, or a Mises and say, simply, "Why not try freedom?"

In any case, the kind of profiling and background check done above on the family history of the Hindenburg Program suggests that schemes of this kind do not derive from the helpless situation of men who are forced to create collectivism against their will. Instead, the totalitarian ethos of the twentieth century, whether in the "mixed" version of the Hindenburg Program or the Bolshevik version of Lenin and Stalin, emerges from the will of individuals who propose to control their fellows. Moellendorff appropriately took as his personal motto a phrase from Walter Rathenau: *Wirtschaft ist nicht mehr Sache des einzelnen, sondern Sache der Gesamtheit* (The economy is no longer simply a private affair, but the affair of the community.) Well, yes, but based on community decisions made by technocratic adminstrators such as . . . himself.

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# ENTREPRENEURSHIP AND ECONOMIC GROWTH: COMMENT ON HOLCOMBE

JÖRG GUIDO HÜLSMANN

Economic growth is determined by two elements, (a) by the available quantities of goods that can be used in the productive process and (b) by the adroitness with which these available factors of production are combined. Dealing with element (b), Randall G. Holcombe[1] has recently emphasized the importance of entrepreneurial activity with a valid and interesting observation. Unfortunately, he does not pursue this observation to the conclusion to which it naturally leads (and which I will therefore have to spell out in what follows), but instead tries to relate it to Israel Kirzner's theory of entrepreneurship. This makes Holcombe's analysis deficient in several respects, with the result that potentially disastrous policy recommendations might be derived from it.

The valid and interesting observation that I have in mind can be grasped from the following example given in Holcombe's article:

> Somebody had the idea that if a computer mouse communicated with the computer via an infrared connection, the mouse could be used without a cord. . . . The profit opportunity arose solely because of a previously nonexistent market niche, and once that market niche appeared, it did not take very long for an entrepreneur to seize on the idea. . . . Before personal computers used mice . . . , there would have been no possibility for the insight, regardless of how far the market was out of equilibrium. . . . This entrepreneurial insight capitalized on a new opportunity, which was created by other entrepreneurial insights. (p. 54)

Holcombe here illustrates the importance of the "context" of action for economic growth. Entrepreneurial decisions are not taken in a time- and space-less vacuum, but under specific conditions, which permit the successful performance of some actions *and* preclude the success of other actions. Entrepreneurs thus have to choose carefully how to use their factors of production. They can only succeed if they do what, under the *prevailing conditions*, is most important in the eyes of the consumers. Yet, irrespective of whether they succeed or not, they change these very conditions and thus *other* entrepreneurial activities become successful and unsuccessful. Two general conclusions immediately follow.

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[1] See Holcombe (1998); page numbers throughout refer to this article.

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First, entrepreneurial judgments are "historical" judgments, that is, they have to grasp the unique combination of circumstances that actually prevails and to anticipate, in the light of ongoing events, the unique conditions that will prevail in the future. For their task is not to buy "capital" and hire "labor" to produce a "product," but to buy *specific* goods (infrared lamps) and to hire *specific* labor services (information scientists specialized in the programming of infrared lamps) to produce a *specific* product (an infrared mouse). Thus, only on the basis of correct historical judgments—only if they are good "historians of the future" (Mises 1985, p. 316) can they decide what is best to do here and now.

Second, it is from the outset futile to promote growth by stimulating the production of "capital goods" and "research" or "education." For it is *not* immaterial which factors of production are produced, because one needs specific goods and specific human services, knowledge, and capacities to accomplish what is most important under prevailing conditions. And in order to discern which *specific* goods and services are most important, one must be able to compare their importance in terms of a common unit, which is precisely what monetary calculation permits us to do.

Hence, an analysis of the context-dependence of action leads naturally to the conclusion that economic growth essentially depends on good historical judgments and on the possibility of economic calculation. Yet, Holcombe takes another path. He attempts to make sense of his observations in terms of Kirzner's theory of entrepreneurship, arriving at the general conclusion that "the key element in economic growth is the production of entrepreneurial opportunities" (p. 60).

The crucial point in Holcombe's argument is his claim that entrepreneurship itself *creates more* profit opportunities than would have existed without it: "When entrepreneurs take advantage of some opportunities, the economic environment changes, creating with it additional opportunities. Thus, entrepreneurship leads to more entrepreneurship" (p. 54). If this argument were correct then we would have to consider entrepreneurship as an activity that reinforces itself, a kind of *perpetuum mobile* in human action.

Yet *why* does entrepreneurship itself create *additional* profit opportunities? Holcombe is silent about this point. As I have pointed out above, entrepreneurial activity *shifts* the profit opportunities, that is, it creates some new opportunities while at the same time destroys others. But this does not mean that it creates *more* profit opportunities. In fact, how could such a claim ever be proven? It cannot be proven *a priori* because the question of how many profit opportunities exist is empirical. We can easily posit a technological development—say, for instance, the advent of computers replacing the myriad of profit opportunities associated with marginal improvements in the typewriter—that would appear to destroy more entrepreneurial opportunities than it creates. Yet this is only conjecture; there can be no empirical proof because empirically we can only observe the opportunities that *are* realized in fact. To weigh opportunities created and opportunities destroyed in the balance requires that we know the unknowable: how many other opportunities might have been realized had history taken a different course.

Holcombe seems to have recognized this dilemma. In fact, his only explanation for the thesis that entrepreneurship leads to more entrepreneurship does not focus on the quantity of existing profit opportunities, but on the *perception* of

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these opportunities. He claims that entrepreneurs create a dynamic environment in which the perception of profit opportunities is *facilitated*. Thus he states that "most profit opportunities get noticed by entrepreneurs *because* they are new" (p. 50, emphasis added), and he points to the static ancient Chinese economy where "one is not likely to spot an entrepreneurial opportunity today that was not apparent yesterday" (p. 52).

However, Holcombe again fails because he does not explain *why* the perception of profit opportunities is facilitated by change as such. Lack of change was indeed not the only feature that distinguished ancient China from Europe, and it could well be the consequence rather than the cause of a lack of entrepreneurial spirit. Thus, Holcombe's thesis boils down to a mere assertion that cannot be proven any more than his other claim, that entrepreneurship creates additional profit opportunities. It is, furthermore, clear that Holcombe's perception thesis implies a passive view of man and thus contradicts the existence of choice. *Either* acting man chooses where to turn his perception, *or* his perception is caused by external events. Only if the former holds true can there be something like an economic science. If the latter were true, we would have to study human action in the way the natural sciences deal with their subjects.

Moreover, what political conclusions are likely to be drawn from Holcombe's view of entrepreneurship as "the engine of growth"? As he himself points out, "the emphasis shifts toward the creation of an environment within which opportunities for entrepreneurial activity are created, and successful entrepreneurship is rewarded" (p. 58). I submit that this by no means precludes government intervention. If economic growth were really stimulated by change as such, why should government not start to interfere randomly in the economy?

Hence, Holcombe's attempt to put a valid observation into the Procustrean bed of Kirzner's theory of entrepreneurship leads to inescapable analytical contradictions and to possibly disastrous policy conclusions.[2]

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[2]For a detailed critique of Kirzner's theory, see Hülsmann (1997).

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# Economic Growth and Its Causes: Comment on Holcombe

Frank Shostak

In his article "Entrepreneurship and Economic Growth," Professor Holcombe (1998) argues that Kirznerian entrepreneurial alertness enables market actors to spot previously unnoticed profit opportunities. Entrepreneurs then act upon these opportunities. As a result, the economy becomes more productive because now more consumer satisfaction can be produced at a lower cost. This is a creative application of the Kirznerian theory, but one that nonetheless suffers from the weaknesses of the theoretical foundation on which it is based.

According to Kirzner, for analytical purposes human action can be divided into a mechanical aspect and a purely entrepreneurial aspect. Once we have adopted this view, Kirzner rightly maintains, "we have automatically excluded the asset owner from an entrepreneurial role. Purely entrepreneurial decisions are by definition reserved for decisionmakers who own nothing at all" (Kirzner 1973, p. 47). The function of the entrepreneur in this framework is to be alert; that is, "simply to know where these unexploited opportunities exist. All he (the entrepreneur) needs is to discover where buyers have been paying too much and where sellers have been receiving too little and to bridge the gap by offering to buy for a little more and to sell for a little less" (ibid., p. 41).

Entrepreneurial profit, then, is not a yield on exchange or production but simply the difference between the two sets of prices. For that reason, "the discovery of a profit opportunity *means the discovery of something obtainable for nothing at all.* No investment at all is required; the free ten-dollar bill is discovered to be already within one's grasp" (Kirzner, p. 48; emphasis in original).

This view of entrepreneurship can be distinguished from that advanced by Murray Rothbard, who argued that for profit to emerge, one needs to employ assets.

> Profits, after all, are simply the other side of the coin of an increase in the value of one's capital, losses are the reflection of a loss in capital assets. The speculator who expects a stock to rise uses money to purchase that stock; a rise or fall in the price of stock will

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> raise or lower the value of the stock assets. If the prices rise, the profits are one and the same thing as the increase in capital assets. (Rothbard 1997b, p. 247)

While stating that the pure entrepreneur cannot have assets, Kirzner, however, argues that we must view the pure entrepreneur "as *hiring* all the talent needed to organize factors of production into a smoothly working team and as *buying* all the resources needed to effectively complete the transactions which his entrepreneurship suggests he enter into" (Kirzner 1973, p. 45; italics in original). But how is all this possible if the Kirznerian entrepreneur does not have assets? According to Rothbard (1997b, p. 247), ideas alone are not enough to exploit profit opportunities. "I might be keenly alert to a profit opportunity virtually lying at my feet. I may have a sure tip on the stock market. But if I haven't got any money to invest, the profits, perceived opportunity or not, will simply not be made."

One might respond to this problem by arguing that the "pure entrepreneur" is merely an analytical device to help us isolate what distinguishes his contribution from other market actors; in the real world, of course, the entrepreneur does own assets. Kirzner has in mind the desire to distinguish the entrepreneurship from the purely passive economizer; "it is analytically expedient to treat [the entrepreneur] as if he represented two entirely separate decisionmakers, one a passive economizer, the other a pure entrepreneur" (1973, p. 43).

However, the purpose of abstraction is to help to grasp the facts of reality and not to obscure them. By viewing human action as comprised of two separate parts—the mechanical and the conscious—we are no longer dealing with human beings but with pure thought experiments. The mechanical aspect of the entrepreneur, although it is part of the real world, is unconscious and automatic, while the other part is pure consciousness disembodied from real objects. Because the two parts are separate and not integrated, neither part can secure actual entrepreneurial profits: unconscious beings cannot know how to earn profits, while conscious but assetless beings can observe profit opportunities but not realize them. The Kirznerian entrepreneur, then, is not a human being but an abstraction. This entrepreneur can observe, but he does not confront risk and does not suffer losses.

It is for this reason that Rothbard (1997a, p. 128) asks, "if superior alertness accounts for entrepreneurial profits, what in the Kirznerian world can account for entrepreneurial losses?" As an alternative, Rothbard points to the Misesian idea of the entrepreneur. He "*takes risks* that he can make profits by risking resources and through superior forecasting of the future, while suffering losses from inferior forecasting." The Kirznerian entrepreneur confronts neither risk nor uncertainty (ibid.; emphasis in original).

How, then, can it be that Kirzner's disembodied phantom is a promoter of economic growth? Professor Holcombe suggests that the Kirznerian entrepreneur promotes economic growth by creating an environment that is suitable for growth. In this environment, innovations are built on themselves, leading to continually increasing productivity. Thus Holcombe (p. 51) writes, "When entrepreneurs take advantage of profit opportunities they create new entrepreneurial opportunities that others can act upon. Entrepreneurship creates an environment that makes more entrepreneurship possible."

To illustrate the point, Holcombe suggests that entrepreneurial opportunities come from the actions of other entrepreneurs. By way of example, "Bill Gates

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could not have made his fortune had not Steve Jobs seen the opportunity to build and sell personal computers, and Steve Jobs could not have built a personal computer had not Gordon Moore invented the microprocessor" (pp. 50–51). There is no particular reason not to regress further in time with this analysis. If not for all past inventors, Bill Gates also would not be able to make his fortune; one might even suggest that if not for the Greek philosophers, Bill Gates could not have succeeded. This scenario is indisputable because it simply depicts the evolution of human ideas.

But this is not actually how it came to be that Bill Gates made his fortune. It was not mere knowledge of the technological capacities or marketing success of the microprocessor that made him rich. It is because he raised and risked his own capital when other people were unwilling to do so. He certainly utilized the existing capital structure, which also included personal computers introduced by Steve Jobs. However, the crux here is that Bill Gates bore the risk and he might have wrongly judged the needs of consumers. Mises argues that this capacity for sound judgment, this entrepreneurial talent,

> cannot be bought on the market. The entrepreneurial idea that carries on and brings profit is precisely that idea which did not occur to the majority . . . the prize goes only to the dissenters, who do not let themselves be misled by the errors accepted by the multitude. What makes profits emerge is the provision for future needs for which others have neglected to make adequate provision. (Mises 1966, p. 898)

Adam Smith also saw entrepreneurship as the engine of growth, while David Ricardo held that the main driving forces are land, labor, and capital. According to Professor Holcombe (1998), the Smithian has a greater claim to validity than the Ricardian view. But from the Misesian–Rothbardian perspective, both theories are flawed. Economic growth cannot be set in motion by entrepreneurial activity apart from land, labor, and capital, and it cannot emerge from land, labor, and capital apart from entrepreneurship. It is the integration of entrepreneurship with land, labor and capital that sets in motion economic growth. The link to this integration is provided by the pool of funding (Strigl 1999, p. 30). This pool comprises of various goods and services that are required to accommodate individuals's needs.

An increase in the pool of funding permits the lengthening of the production structure, which permits increases in the output of consumer goods and permits the production of goods that previously could not be produced at all. Any lengthening of the production structure must accord with what the pool of funding can support. Thus, if the size of the pool of funding is sufficient to sustain a production structure of one year, any attempt to lengthen the structure beyond the one year must fail. The pool of funding therefore sets a brake on the use of the more productive but longer stages of production.

Individual time preferences, as manifested by the pure rate of interest, determine how much of a given flow of real wealth is allocated towards consumption and how much towards saving, and hence towards the pool of funding. A lowering of time preferences, i.e., lowering of the pure rate of interest, implies that people are now more willing to wait for any given amount of future output (Rothbard 1993, p. 488), implying that they are ready to allocate means of sustenance towards longer stages of production. A rise in the time preferences and in the pure rate of interest means that people are less willing to wait. This means that they will

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allocate proportionately more of the means of sustenance towards the production of consumer goods and less towards the longer production stages (ibid.). Following the law of diminishing marginal utility, it is possible to infer that (all other things being equal) increases in real wealth correspond to declining pure rate of interest. This decline in turn gives rise to more real wealth and in turn to a further decline in the pure rate of interest (p. 380). It follows then, that a growing economy establishes, as it were, a self-reinforcing mechanism which expands the pool of funding. According to Mises, "at the outset of every step forward on the road to a more plentiful existence is saving—the provisionment of products that makes it possible to prolong the average period of time elapsing between the beginning of the production process and its turning out of a product ready for use and consumption" (Mises 1966, p. 867).

The pure rate of interest fulfills the crucial role of coordinating between the length of the production structure and the pool of funding. The introduction of money does not alter the essence of the analysis we have presented so far. To fulfill the role of the medium of the exchange, the money stock must remain unchanged. This will guarantee that production will precede consumption. It will also guarantee that money is fully backed up by the saved means of sustenance. Whenever a producer exchanges his goods for money he acquires a permit to access the pool of funding whenever he requires. By exchanging his goods for money he enables the buyer of his goods to engage in production, thereby allowing the overall production flow to stay intact.

Economists following the writings of Frank Knight hold that savings are of little importance in the modern economy. The modern infrastructure, it is held, automatically generates its own funding, which in turn is employed for its maintenance and expansion (Rothbard 1993, p. 343). An infrastructure, however, cannot maintain itself automatically since if people decide to save less, then less funding will become available. Irrespective of the complexity and sophistication of the production structure, without the expansion in the pool of saved means of sustenance no economic growth can occur. According to Menger, "the process by which goods of higher order are progressively transformed into goods of lower order and by which these are directed finally to the satisfaction of human needs is . . . not irregular but subject, like all other processes of change, to the law of causality" (quoted in Salerno 1999, p. 81). Salerno argues that "by proceeding this way, Menger was able to perceive immediately that the process of want satisfaction is not purely cognitive and internal to the human mind, but depends crucially upon the external world and, therefore, upon the law of cause and effect" (ibid., p. 79).

To convert elements of nature into means of sustenance, people must employ tools that are suitable for this task. According to Holcombe however, what causes the expansion in the means of sustenance is entrepreneurship. However, entrepreneurship cannot fulfill the role of a factor of production as such. For it cannot be employed in the direct process of converting elements of nature into the means of sustenance. This doesn't mean that entrepreneurship is not important; indeed, it is indispensable in every stage of every production process. According to Rothbard (1993, p. 9) for any action there must be always a plan or idea about how to use things as means to particular ends. Without such ideas there cannot be actions.

Yet, the implementation of entrepreneurial ideas cannot be done in a vacuum. The entrepreneur must mobilize the necessary funding for this task. Only with a

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pool of funding can entrepreneurship become effective. As Rothbard (1997b, p. 247) writes, "Entrepreneurial ideas without money are mere parlor games until the money is obtained and committed to the project." Salerno (1999, p. 90) further argues that "Menger states explicitly that command of the services of capital is a 'necessary prerequisite' for performing economic activity." Mises warns that, "Neither have capital or capital goods in themselves the power to raise the productivity of natural resources and of human labor. Only if the fruits of saving are wisely employed or invested, do they increase the output per unit of the input of national resources and of labor. If this is not the case, they are dissipated or wasted" (Mises 1972, pp. 84–85). He also writes that the "accumulation of net capital and the utilization of capital for raising the productivity of human effort are the fruits of purposive human action" (ibid.). It follows then that it is not the Kirznerian entrepreneur who contributes to economic growth, but only an entrepreneur who employs funding in accordance with consumers' most urgent needs.

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# ENTREPRENEURSHIP AND ECONOMIC GROWTH: REPLY

RANDALL G. HOLCOMBE

Frank Shostak and Jörg Guido Hülsmann have written thoughtful comments on my article, "Entrepreneurship and Economic Growth" (1998). In some places, I agree with them but believe clarification is worthwhile, and in other places I find myself in disagreement. Despite the fact that we do not always agree, I appreciate their interest in the issues. The relationship between entrepreneurship and economic growth is an important one, and one that Austrian economic analysis has much to offer. Thus, with my comments below I hope not to have the last word, but to encourage Shostak, Hülsmann, and others to further apply Austrian insights to the topic of economic growth.

## KIRZNERIAN ENTREPRENEURSHIP AND GROWTH

Shostak devotes a substantial portion of his comment to a critique of Kirzner's theory of entrepreneurship. I will not defend Kirzner's ideas here, partly because Kirzner can defend his own ideas, and partly because I too think of entrepreneurship more broadly than Kirzner. That said, there are two reasons why I focus on Kirzner's concept of entrepreneurship specifically. First, many of my own ideas developed from my reading of Kirzner. I admire both Professor Kirzner himself and his work, and want to give credit where credit is due. Second, Kirzner's ideas are well-known, and I believe that I have something substantial to add to them. By working in a Kirznerian framework, I can start with a foundation that will be familiar to many readers. Kirzner's analysis starts in an environment where entrepreneurial opportunities already exist, and he discusses the entrenrepeurial role of discovering these opportunities. My article shows that entrepreneurship itself creates new entrepreneurial opportunities, thus serving the dual function of (1) making Kirzner's model more complete by explaining one origin of entrepreneurial opportunity, and (2) creating out of Kirzner's theory of entrepreneurship a theory of economic growth.

## SAVING, INVESTMENT, AND GROWTH

Shostak argues, "Irrespective of the complexity and sophistication of the production structure, without an expansion in the pool of saved means of sustenance no economic growth can occur" (p. 70). He cites Mises to suggest that the only way

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for economic growth to occur is for saving to increase so that the structure of production can be lengthened. Without taking issue with his interpretation of Mises, Shostak's idea that the structure of production must be lengthened, or more capital must be invested, for growth to occur is wrong.[1] Of course, investment and lengthening the structure of production can lead to growth, but entrepreneurial insights that find ways to reduce the amount of capital necessary for production, and to shorten the structure of production, can also promote growth by reducing the time and resources required in production.

A good example of this is the adoption of "just in time" production, where rather than holding an inventory of inputs into the production process, the flow of inputs is managed so that they arrive just in time for their use. By adopting just in time production techniques, the amount of investment in inventory is reduced, as is the amount of investment required for physical storage of inventory waiting to be used. The implementation of this entrepreneurial insight reduces the amount of investment required to produce output and, even more in line with the temporal nature of Austrian capital theory, actually shortens the time between stages of production. In this example, productivity increases by reducing the amount of capital used, and by shortening the structure of production, contrary to Shostak's assertion. One might argue that the structure of production refers to stages of production rather than calendar time. But as Lewin (1996) notes, some producers have reduced costs by selling directly, eliminating the distributor or middle-man, which obviously eliminates a complete stage in the structure of production. Reflecting on some examples shows that growth can occur without additional saving, but also suggests that the relationships between capital, entrepreneurship, investment, and growth are fruitful areas for further research.

Additional examples range from the obvious to the subtle. Some corporations that formerly had offices for employees who traveled often found that most days, most of their offices were unoccupied. In response, they eliminated permanent office assignments and assigned offices to employees only on days when they actually were at the office, reducing the total amount of office space they used. This is a clear case of productivity enhancement through a reduction in the use of capital. Technological advances offer more subtle but perhaps more spectacular examples. In aircraft manufacture, for example, a new generation Boeing 757 has less than half as many parts as the older 707, enabling it to be manufactured more quickly and inexpensively. Similarly, new airliners are designed using computers and software rather than by building prototypes, reducing the amount of capital used in aircraft design, and in line with Austrian capital theory, shortening the structure of production by reducing the actual time from design to manufacture.[2] Examples can illuminate the point, but the general idea is that entrepreneurial

[1] See Lewin (1996) for an insightful discussion of Austrian capital theory. He notes some difficulties even in trying to measure the length of the structure of production (see, for example, pp. 148–52), but there is less ambiguity in measuring the amount of saving than the length of the structure of production. In any case, Lewin notes that technological innovations can create growth by shortening the structure of production.

[2] This example might be interpreted differently. If the use of computers is viewed as adding a stage (or more) to the structure of production, then the example illustrates how the structure of production, measured in stages, can lengthen even as the time of production and the dollar investment in capital is lessened. Again, Lewin (1996) discusses the ambiguities in actually determining what constitutes a stage in the structure of production.

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insights often involve methods of reducing the capital used in production, or shortening the production process, which enhances productivity and growth. Examples aside, one can see that in principle, an entrepreneurial insight can lead toward producing goods using less capital or by shortening the amount of time involved in production.[3] Thus, economic growth can occur without additional investment, and can occur without lengthening the structure of production.

Of course, investment in capital goods and lengthening the structure of production is an important contributor to growth. Henry Ford's adoption of the assembly line is a good example. My point in this section is that entrepreneurial insights often lead toward ways to shorten the structure of production or to reduce the use of capital, and in these cases growth can be enhanced without additional saving and investment.

### THE MICROSOFT EXAMPLE

My article used Microsoft as an example, saying that Bill Gates made his fortune by capitalizing on entrepreneurial opportunities created by earlier innovators in the computer industry. Shostak challenges this, saying that Gates made his fortune "because he raised and risked his own capital when other people were unwilling to do so." This is a factual error, and correcting it can help illuminate the nature of entrepreneurial opportunity. In fact, many people risked their capital to try to capture the market that Gates eventually dominated. Steve Jobs and Steve Wozniak tried to interest major computer companies in their personal computer, and when those established companies failed to recognize the opportunity, founded their own company, Apple Computer, risking their own capital. The Apple operating system predates Microsoft MS/DOS, and the Macintosh windows operating system predates Microsoft Windows. Furthermore, when Gates entered the market with MS/DOS (and the PC/DOS variant sold with IBM personal computers), the PC operating-system market was then dominated by the CP/M operating system, written by Gary Kildall and sold by his company Digital Research (DRI). Kildall and DRI negotiated with IBM to use CP/M as an IBM PC operating system, and only when talks between Kildall and IBM broke down did IBM strike an agreement with Gates and Microsoft.[4] But Gates even had competition for the IBM PC operating system. Originally, PC/DOS software was sold separately from the PC hardware, and IBM originally offered a choice of three different operating systems (including UCSD Pascal, supported by a state university), with Microsoft only supplying one

[3]This point refers to the amount of time required to produce a particular good, and not to the length of the structure of production in general. If the structure of production for aircraft is shortened, for example, but there is no change in time preference that would warrant a change in the interest rate, this would free some investment funds that could be used to lengthen the structure of production for other goods or could cause an economy-wide shift toward goods with longer production structures. Thus, the structure of production could be shortened for one good but remain unchanged for the economy as a whole after adjustments in other markets.

[4]The brief background reported here was culled from several web sites after doing an internet search on "Gary Kildall" and "Digital Research." Interested readers can follow-up this way, and this story sheds much light on the early evolution of the PC industry. The internet itself is an interesting example of a technology that in many ways conserves capital, apparently (because it relies heavily on pre-internet communications infrastructure) saving more capital than it consumed to create. While particular entrepreneurs have profited from insights on how the internet might be used, its evolution as a commercial and communications medium falls more in the category of a result of human action but not of human design, in line with Hayek's idea of economic evolution.

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of the three choices. Also, at that time (early 1980s) Radio Shack was a large corporate player in the PC industry with their own proprietary TRS-80 operating system. Then, in the late 1980s, when Microsoft split from IBM to compete on its own, IBM competed with their OS/2 operating system. Many competitors, both corporate entities and individual entrepreneurs, risked their own capital in the PC operating-system market.[5]

The point is that when this new entrepreneurial opportunity arose, it was noticed and acted upon by many entrepreneurs who risked their own capital. Steve Jobs and Gary Kildall are two individuals who clearly risked at least as much as Gates (who had the corporate support of IBM). In addition, many corporations and even state universities were competing for the market Gates eventually came to dominate. In hindsight, we can analyze what enabled Gates to dominate the market, but Shostak is clearly wrong that Gates was the only one willing to risk his own capital to compete in that market. A new entrepreneurial opportunity was created that did not exist five years prior, and many individuals quickly saw the opportunity and attempted to capitalize on it.[6] This is consistent with my argument that once entrepreneurship creates new opportunities, they tend to be noticed and acted upon rapidly. Shostak asserts a fact (that Gates was the only one willing to risk his own capital) in support of his argument, but Shostak is wrong on the facts, and the true facts support the thesis of my original article.

## Entrepreneurship and the Creation of Additional Entrepreneurial Opportunities

Hülsmann misunderstands one point in my article, and a clarification is in order. One of my main points is that entrepreneurship creates additional entrepreneurial opportunities, but Hülsmann is correct to note that it also destroys other entrepreneurial opportunities. I did not mean to imply that the number of new opportunities created will exceed the number of old opportunities destroyed, and agree with Hülsmann that it would be impossible even in principle to know whether the number of new opportunities created exceeds the number of opportunities destroyed. However, it is clear that the new opportunities created must make better use of resources than the old opportunities destroyed, because if they did not, the old opportunities would still be potentially profitable. This is the key point. As Hülsmann noted, the actual number of opportunities is in principle unknowable, and is irrelevant to the relationship between entrepreneurship and growth. However, the newly created opportunities must be better suited to satisfying human wants than the old ones that are displaced, which creates an environment conducive to growth.

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[5]A similar story could be told in the applications market, where Wordstar, WordPerfect, and Lotus 123 once dominated the markets that Microsoft came to rule with its Office software.

[6]Interestingly, both Apple and IBM sought to enter the market by bundling their operating systems with their hardware, while Kildall and Gates did not sell PCs that ran their operating systems. In hindsight, the bundling strategy appears inferior, although it is unclear why, because computer software is a relatively non-excludable joint consumption good, and bundling can provide a method for controlling the good's distribution. See Holcombe (1997) for a further discussion of the issue. The point is that, many people perceived the availability of the recently-created profit opportunity that Gates capitalized on, and many people risked their own capital to try to make those profits. The availability of profits was noticed by many, but one person was much more successful at producing what was required to get those profits.

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Hülsmann makes a more substantial objection to my thesis that entrepreneurship creates additional entrepreneurship. He says, "*Either* acting man chooses where to turn his perception, *or* his perception is caused by external events. Only if the former holds true can there be something like an economic science" (p. 65). But Hülsmann offers a false dichotomy. Man can both choose where to look and can be influenced by his environment. For example, when a fire truck roars by, its siren blaring, that external event causes people to notice and stay clear. If sirens did not alert people by affecting their perception, there would be no point in putting them on emergency vehicles. Entrepreneurial activity attracts attention in much the same way as a fire truck's siren. At the end of the twentieth century, the attention of many entrepreneurs is attracted by developments in the computer industry because external events signal them that there are many profit opportunities available. This in no way says that people cannot choose where to look for profit opportunities, emergency vehicles, or anything else.[7]

## THE ENVIRONMENT FOR ENTREPRENEURSHIP AND GROWTH

Hülsmann ends his comment by drawing a completely mistaken policy conclusion from my analysis. He says, "If economic growth were really stimulated by change as such, why should government not start to interfere randomly in the economy?" (p. 65). I never said that growth is stimulated by change, I said that growth is stimulated by entrepreneurship. Thus, the policy conclusion implied in my analysis is that policies that foster entrepreneurship create growth. While my article did not discuss the policy implications directly, in other recent work co-authored with James Gwartney and Robert Lawson (1999) I do take up the issue and find that lower taxes and government expenditures lead to more economic growth, that protection of property rights enhances growth, and that less government regulation, greater monetary stability, and the absence of prohibitions on voluntary exchange enhances growth.

The policy questions are important because while much of the world has seen substantial economic growth in the last half of the twentieth century, many nations are being left behind, and as Krueger (1993, 1997) has argued, economists have contributed to the plight of some slower-growing nations by giving them inappropriate policy advice based on neoclassical growth theory. Thus, growth theory is of more than just theoretical interest, and in this area, the Austrian School has much to contribute. As my original article indicated, mainstream growth theory focuses on the role of inputs and technology, but inputs and technology cannot produce growth without an environment that fosters entrepreneurship. Echoing Krueger, I believe that the application of mainstream growth theory has often been harmful to economic growth because the mainstream theory ignores the market process. The purpose of my original article was to show that entrepreneurship is an integral part of the process of economic growth, and to illustrate the advantages of the Austrian approach to growth over the mainstream approach. While my original article focused mainly on the theoretical implications, ultimately the policy differences

[7] In the purely Kirznerian setting, people just observe profit opportunities, and looking for them implies an investment activity outside of narrow Kirznerian entrepreneurship. Like Hülsmann and Shostak, I take a broader view of entrepreneurship and do think that entrepreneurship can include people who actively seek out profit opportunities. Even though they make this choice, their perception still can be influenced by external events.

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between the approaches are more significant, and offer an important reason for additional development of the Austrian approach to economic growth.

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# *THE ILLUSION OF CHOICE: HOW THE MARKET ECONOMY SHAPES OUR DESTINY.* BY ANDREW BARD SCHMOOKLER. ALBANY: STATE UNIVERSITY OF NEW YORK PRESS, 1993

In recent years, there has been a remarkable resurgence of socialist and social-democratic theorizing, this time, allegedly, with a quite different twist (Pongracic 1997, pp. 599–600). These theorists still regard capitalism as characterized by exploitation, inequality, and negative externalities. But they are now forced to admit some of capitalism's advantages and the serious deficiencies of socialism. All this notwithstanding, these post-socialist writers espouse a frightfully similar logic to socialists of old: While socialism may only seem dead, theoretically, it still has much to offer. And because capitalism is simply wrong as a socio-economic system,[1] and has little to offer *theoretically*, a third way is proposed as the *sine qua non* of a just and humane society.[2] Despite their claims to originality, these authors are not very original: in almost all cases either a more interventionist government is offered, or a new variant of market socialism sought.[3]

One topic is especially dear to all post-socialists: the philosophical issue of choice. Choice, for them, is illusory, nonexistent, a mirage, never absolutely free, so the only moral reason for free markets rests, as it were, on shaky grounds. Once we understand that, they tell us, we will give up choice and be more open to some sort of scientific planning. As Bellamy (1994) argues, some economic events erode particular choices while expanding others and "[e]ven if one accepts that the quantity of choices is probably (if not necessarily) increased for the majority by [those events], this tells us nothing about the intrinsic worth of these choices for human beings" (p. 349). So it is a "wider moral framework within which markets operate"(p. 356) that must never be overlooked when social systems are discussed.

Andrew Bard Schmookler's *The Illusion of Choice* is an almost perfect example of this post-socialist scribbling. I was drawn to the book by some words of praise. According to one writer, it is "an extraordinarily deep, broad, and insightful analysis

[1]Robert E. Lane (1994) even claims that capitalism produces "a rising tide of clinical depression and dysphoria, a decline in mutual trust, and a loosening of social bonds." His advice: "Advanced societies are likely to increase 'utility' if they maximize friendship rather than the getting and spending of wealth" (p. 521). Since "the market inhibits friendship and other kinds of social support" (p. 522), and since "market solutions to the deficit of companionship in modern society have failed," as well as the welfare state (p. 544), his conclusion is a weak recommendation of a society in which "we seek to cultivate the bonding instincts with which we are born" (p. 546).

[2]In its recent catalogue, Rowman & Littlefield Publishers advertises Michael W. Howard's *Self-Management and the Crises of Socialism* (August 1998) as an "exciting text." "While some conclude from the revolutions of 1989 that socialism is dead, interest in socialism continues because of persisting problems of contemporary capitalism."

[3]See Bowles, Gordon, and Weisskopf (1990), Lane (1991, 1994), Yunker (1992, 1993), Bardhan and Roemer (1992,1993), Cottrell and Cockshott (1993), Schweickart (1993, 1997), Bellamy (1994), Roosevelt and Belkin (1994),Roemer (1994), Wainwright (1994), Vanek (1996).



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of the social, political, and moral consequences for our civilization of our dependence on the market system."[4] The author of a work with the ominous title *The Death of Industrial Civilization, finds the book "clear and engaging." Dealing with "difficult and often overlooked implications of the market" the book "address[es] the hoary but necessary issue of the manner of social change for advanced industrial society."*[5] Another critic is convinced that "The author is at the heart of the biggest ills of our time."[6]

I must, *en passant*, add that I am stunned by some of these statements. They cannot possibly mean what they're saying. Is the market system really one of "the biggest ills of our time?" Even compared to Communism and Nazism, Stalin and Hitler? Was Pol Pot's agrarian communism really superior to a market economy? Can an advanced industrial society really be better off in a socialist setting? What kind of experience have these people had with other systems to bring such a sweeping generalization against the "market system?" [7]

Anxious to discover Schmookler's proposed alternative, we actually find another unsuccessful endeavor to find the Holy Grail of modern post-socialism—the beloved third way. Like other market critics, Schmookler is not humble. He presumes to know the answer to every question concerning society, man, environment, technology, or any of the complex issues that humans confront in everyday life. A research associate at Harvard University's Center for Psychological Studies in the Nuclear Age, he has goals that can only be described as gigantic. He wants "to create a more humane and viable civilization" (p. 3), "a civilization that is viable and fulfilling to the human spirit" (p. 4), "a social order superior to ours" (p. 14), "a radical transformation in our political economy and in our consciousness" (p. 28), in a word, "a world at harmony" (p. 262) His is "a vision of the world in which how we live is governed solely by the true expression of the human spirit" (p. 271). "We can be free," cries Mr. Schmookler, "but only if we recognize and treat our bondage as a problem" (ibid).

To "bring our systems"—yes, the whole world—"under genuine human control" (p. 305) is, for Mr. Schmookler, an exercise in pure logic: "The global order, in turn, would be structured so as to make the world safe for these diverse and humane societies" (p. 299). He is never in doubt that, if we only followed his recipe, "we would create wonderful culture, that we could live in harmony and nourish each other, and that the flower of human creativity would bloom in diverse and marvelous and unexpected ways" (p. 260).[8]

His enemies are "the insatiable materialism of our civilization, . . . [that] is killing the earth" (p. 3), "our ceaselessly escalating race for material wealth" (p. 4), "our society's voracious drive for wealth" (p. 5), "the sickness of our materialism" (p. 33), "the deadly deficiencies of our modern economy," (p. 34) "the continual erosion of the fabric that holds things together" (p. 72), "a superfluous private abundance and an impoverishment of the public realm" (p. 95), the "limitless quest for growth" (p. 228), "this

[4]Lester Milbrath, the author of *Envisioning a Sustainable Society*, on the back cover of the book.

[5]Joel Jay Kassiola, on the back cover of the book.

[6]David W. Orr, the author of *Ecological Literacy*, on the back cover of the book.

[7]One of the most disturbing facts is that all the above mentioned critics of the market sincerely believe that here in America we have a "free" market in which greedy capitalists are completely free to rape the land, exploit the workers, cheat the customers, and do more or less whatever they want.

[8]F.A.Hayek, whom Schmookler vilifies whenever he can, but obviously knows only from secondary sources (no original works by Hayek are in the bibliography), called such a logic (1944) giving "the prestige of a scientific appearance to passions of their hearts" (1944, p. 191).

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economy of insatiability" (p. 232), "a system that drives us relentlessly toward more and more" (ibid.), "a single-minded devotion to accumulating great fortunes" (p. 286), and especially "the illusion of choice."

The main culprit for all this is . . . the market, a "monster, run amok" (p. 176),[9] a "system that is blind to the values of the natural world" (p. 76), "slow to recognize the reality . . . that the world is finite" (p. 98 ) and "by its nature, treats the earth like dirt" (p. 96), ultimately a "system of intersocial interaction where anarchy and its partner, violence, hold ultimate power" (p. 258). This "system, because of its biases and distortions, *carries us to a destination chosen by that system and not by us*" (p. 25, italics in original).

From the outset, Schmookler tries to convince us that he is smarter than previous critics of the market system. He, for example, understands that the "market system works miracles" (p. 8). It was "the workings of the market system [that] have helped to raise regions and nations out of poverty and into affluence" (p. 235).[10] He, on the other hand, also understands that "communism stands discredited" (p. 19) by "the shameful ecological record of communist economies in Europe" (p. 108). "Marx," admits Schmookler, "for all his brilliance and frequently penetrating insights, opened the wrong path" (p. 21).

Aware of all "misguided, utopian strivings for perfection" (p. 73), he wants to go "beyond Marx" (p. 21). Realizing that government interventions, "for a variety of reasons," "compound the vices of the market, while others impair the market's virtues" (p. 26), and realizing that the market system "cannot be perfect," that "[e]ven wise choices involve trade-offs" (p. 10), and that "[c]orporate decisions are always being made in the face of uncertainty" (p. 200), he offers his own blueprint for an (almost) perfect society.

It needs to be said that, after all this exercise in the philosophy of reality, one would expect Schmookler to be more friendly toward market solutions. Not so. According to Schmookler, "to conclude from these obvious facts that the market allows people to choose their destiny is a widespread and enormously influential fallacy" (p. 11). It is this problem of choice that forces Schmookler to pronounce the market the root of all evil, and to sentence it to death.[11]

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[9]How far Schmookler goes in this market-as-a-person treatment is best seen in the following sentences: "The market sees no value in treating the Black Hills as sacred, particularly if there's gold to be blasted out of them. When the market beholds a thousand-year-old redwood tree, what it sees is picnic tables, house siding, and mulch" (p. 261).

[10]As with Schmookler, Bardhan and Roemer (1992) first admit that "competitive markets are necessary to achieve an efficient and vigorous economy" (p. 101), only to destroy the workings of the market through their hatred for private ownership in the means of production at the end of the article. See also Wohlgemuth (1997) and Gordon (1995).

[11]Cornell University economist Jaroslav Vanek (1996) seems to agree with Schmookler. According to Vanek, accepting the market philosophy puts us on the "road to serfdom." Though Vanek wants us to believe that he is only against "modern oligopolistic capitalism," and would agree to be on the side of the market economy if it did not produce so many "pathologies," his true feelings were best expressed in his view that "the socialist countries of Eastern Europe, with all their crises and inadequacies, may be most capable of operating and initiating the process of healing" (p. 114). Why? They

> have the most extensive experience with economic planning and cooperation. The . . . world . . . need[s] some kind of...economic planning and translating of overall social objectives into actual economic action on the national and regional level. This action would have to be far more comprehensive and democratically based than the *ad hoc* economic policy making in the West today. (p. 123)

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The market, he argues, is positively immoral. In the market "the strong [are] free to do what they can while the weak suffer what they must" (p. 272). Take this example: "If others have found a way to produce a given product more efficiently, other less-efficient means of producing the same thing are rendered impractical. If my more efficient neighbor can make a profit at a price that would be a loss for me, I must either match his efficiency or go out of business" (p. 273). Now, how can such a system call itself moral? Most people believe in the morality of the market simply because they have "a dangerously distorted idea of what constitutes efficiency" (p. 274).

A further example of market immorality is its treatment of poverty. How can anybody say that "the market is the most effective means of addressing the problem of genuine poverty" (p. 235)? After all, the market is a zero-sum game: "[T]he continued growth of the wealthy on this finite planet absorbs scarce resources necessary for significant improvement in the lot of the poor" (ibid.).[12] While "massive resources have been devoted in the course of an entire century to the creation of the consumerist mentality" (p. 234), "there is no place you and I can go to buy a clean environment, a coherent landscape, an intact social community" (p. 62). Transforming the earth, its biosphere and its bowels, into something so trivial as commodities ends up in the paradox that, in the end, some of them we will not be able to buy.

But all this is of secondary importance. The real problem for Schmookler is that "it is the system that decides" (p. 48), "the system, which determines what kind of values and ways of living will be empowered" (p. 288).[13] And when we are denied in the market all "those good things that cannot be bought and sold" (p. 12), we are denied happiness. We perform unnecessary labor to acquire superfluous goods, never realizing that we are "the servants of our own creation" (p. 234). "To understand the importance of what we may have lost—in interpersonal relationships or interpersonal integrity, in community and in a reverent and harmonious relationship with our natural surroundings—requires a breakthrough of consciousness, an awakening to achieve" (p. 15). The market simply divides people to conquer them. For Schmookler, "life and death are at stake" (p. 288).

Morever, "The myth nonetheless persists that our system is the embodiment of liberty. The intrusions of government are still resented as the infringements of a dangerous power upon our personal liberty, even though our democratic polity is more accountable to its collectivity than the modern corporation now is to its" (p. 192). But laissez-faire policies only mock our values and thereby only promote the continued degradation of freedom itself.

For Schmookler, who knows "the real values" (p. 101) and possesses the knowledge "of an *intrinsically meaningful* way of life" (p. 290, italics in original), this is a sick society, "a world no one would choose" (p. 76), and we're called to make "the most fundamental and fateful choice": "to see or not to see" (p. 16). (It is "the ugliness and spiritual vacuity of a landscape contorted by the narrow and uncompromising demands of producing, buying and selling," [p. 11] that especially unnerves Schmookler.) This Shakespearean dilemma is forcing us "to look carefully into the market system" and "its contagious lifelines" (p. 35) and—though "indeed a phenomenal tool for many purposes" (p. 28)—reject it.

[12]The market is even blamed for the fact that "60 percent of women with children under five years of age work outside the home" (p. 213).

[13]"Unless adequately restrained, the market tends to sweep up all other institutions, all other cultural forces, and reform them in its own image" (p. 71).

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Instead of being our servant, the market has become our master, while Schmookler has become our liberator: "The first step in our liberation is to recognize our bondage." "[T]he system must be transformed," cries Schmookler (p. 18). We need "someone at the steering wheel" (p. 25) "to get the vehicle of the market pointed straight on the road to a destination of our choosing" (p. 26), "an adequate countervailing force to act either for steering or braking" (p. 71). "And the only tool available to us that has sufficient power to divert the market's intrinsic momentum is the instrumentality of government" (p. 27), since "a market society cannot correct against the inherent biases of the market except by using the coercive arm of government" (p. 72).[14]

Government may have some faults, Schmookler allows, like incompetence and corruption, but "[h]uman intelligence, exercised through government, is surely capable of improving upon the information with which the market, with its identifiable blind spots, does not work." (p. 80) Why cannot the same human intelligence improve market information? He responds that a system predicated on human selfishness, will not only "encourage the selfish element in our nature," and "fray the moral fabric of our society," it will also destroy one of the fundamental elements of human nature, the "capacity for altruistic feelings and actions" (p. 82). Even with this capacity being salvaged, a solution is viable "only if taxes and subsidies are used to correct the market's inherent bias" (p. 104). Only when we choose together, using the government, will we have "a genuine possibility of choice" (p. 204).

Some time before Schmookler wrote this book, a University of Alabama professor of philosophy accused "critics of capitalism" of having "a great deal to say about the defects and social ills that afflict capitalist society and correspondingly little to say about how alternative institutional arrangements might solve these problems" (Arnold 1992, p. 1). Schmookler's book is an attempt to correct this. Once the people understand his philosophy—let's call it Schmooklerism[15]—the solution comes almost automatically. People become new and different. "The very act of confronting these problems would change people's consciousness" (p. 206). Once they see the world as a whole, everything will change.

So Schmookler's goal is set for him—his solution will show us how to live in "the just and nonviolent order . . . [and how] to remake our present world into the world as it should be" (p. 289). But first he has to "show how a market system, if insufficiently controlled—as ours presently is—drives the society into the very excesses that characterize our world today" (p. 5). We, the unenlightened, are caught in a vicious circle: we think we make choices, but those choices are not ours, they are molded by a society that is the victim of the forces of the market which, in the course of time, destroys the very values it is supposed to satisfy. "Our choices are thus skewed by the nature of the system within which we make them" (p. 11). It is "the market machine [which] allocates resources to maximize both productivity and utility" (p. 39), not we, because "the market economy does

[14]Hayek (1944) forewarned us against this infatuation with "the coercive arm of government." But Schmookler warns us against Hayek: "[T]he whole ideological argument in favor of spontaneous orders is constructed with the sole aim of justifying the market and protecting it from governmental meddling" (p. 74).

[15]Schmookler refuses to label his society. He believes that it would be a new kind of economic democracy that he labels sometimes the "just and nonviolent order" (p. 289), and sometimes "a world free of force" (p. 271), but never socialism. The word does not even appear in the Index.

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indeed have a logic of its own. Once the market system is in place, the people in it are no longer wholly in charge of their destiny" (p. 124). "Human affairs are reduced to terms of mechanism, comprehensible in terms of number and calculation. It is like the Newtonian clockwork universe that epitomized the worldview of the era in which the market and developed its power and rationale" (p. 34). Schmookler seldom blames the people—we are only dupes; rather it is the "insatiability of the mechanical system [which] gains ascendance over the sense of proportion inherent in organic process" (p. 233).

The market economy, that "has long been served by an atomism in our thinking" (p. 207), has denied us "to see the connections between the various elements of our social reality" (ibid.).[16] Even he—as an investor—is guilty of such negligence: "As I put my dividend check in the bank for my daughter's education, I don't have any reason to think about whether the leukemia of someone else's daughter was induced by chemicals my company didn't think it worth the expense to dispose of properly" (ibid.).

At this point, it is easy to become discouraged. If Schmookler himself is a sinner, how can we simple mortals hope to reach his utopia? But he consoles us: "[t]he root cause of the cult of growth [is] to be found not so much in the psychological nature of the people within the system as in the logical thrust inherent in the market economy" (p. 228). Once we eliminate the monster, the market economy, the "economic man" in all of us will miraculously disappear, and the new Schmooklerian Man will emerge. A "healthy economy that is not constantly growing" (ibid.) will result, and once we are masters of our own destiny we will "choose to refuse the demands of the market and . . . allow our children to bloom quite differently" (pp. 260–61).

It could be easy to dismiss Schmookler and his ilk with the Orwellian quip: "You have to belong to the intelligentsia to believe things like that; no ordinary man would be such a fool." We could also echo Antony Flew's recent question: "By what right are you proposing to deploy the forceful machinery of the state in order to impose upon all concerned your own personal . . . vision of an ideal society" (1997, p. 301)? But all this would not suffice—the utopian socialists have to be refuted over and over, because they keep reappearing. It must be explained to them, repeatedly, that using their means they will never achieve their goals.

It was Mises who in *Human Action* explained that people like Schmookler elevate their "personal value judgments to the dignity of a universally valid standard of absolute eternal values." They would impose their own ends, their own arbitrary value judgments on the rest of the population simply because they are convinced they have discovered an incontestable standard of good and evil. "Masked as the benevolent paternal autocrat, the author's own Ego is enshrined as the voice of the absolute moral law" (Mises 1966, p. 660).

Previously, in 1929, Mises had described such people as ones "seeking an ideal system which, in their belief, is neither capitalistic nor socialistic, is based neither on private property in the means of production nor on public property. They are searching for a system of private property that is hampered, regulated, and directed through government intervention and other social forces" (Mises 1929; 1977, p. 13).

[16]Schmookler does not distinguish between methodological individualism and normative individualism (Vanberg 1994).

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Mises believed that most people, whatever their ethnic origin or religion, agree that such a system would be the only acceptable social system, although they may disagree sometimes in the methods how to bring it about. They refuse to see that the objectives which they aim to achieve can never be achieved. "Government cannot make man richer," Mises proved in so many of his articles, "but it can make him poorer" (p. 23).

In his Nobel Memorial Lecture, Hayek warned all the future Schmooklers about a very serious danger—in their arrogance they can destroy the world.

> The recognition of the insuperable limits to his knowledge ought indeed to teach the student of society a lesson in humility which should guard him against becoming an accomplice in man's fatal striving to control society—a striving which makes him not only a tyrant over his fellows, but which may well make him the destroyer of a civilization. (Hayek 1984, p. 276)

Schmookler, and so many other dissatisfied intellectuals, belong to what John Jewkes, the British economist, called "morbid types." According to Jewkes (1948), such people are "[m]en who itch after power to control their fellows. Men of little understanding and less restraint who would smash the existing economic institutions out of pure ignorance of their functions. Egomaniacs who can conceive of no standard of values but their own and strive, with Jesuitical fervor, to save the world despite itself" (p. 5).

Schmookler himself tells us at the end of the book that in order to move toward his perfect society, "we do not need to know much about our destination. It is sufficient to commence with the removal of the obstacles to human freedom. Simply work to restructure our systems to neutralize their power over us, and, with the passage of time, the true nature of our options will naturally unfold before our eyes" (pp. 304–05).

And yet it is an inescapable fact that people in Schmookler's society of the future will need to grapple with the same question we deal with today: Can people be permitted to follow their own preferences within the framework of voluntary exchange and cooperation, or must they follow a common value scale even when they disagree with it? If the common value scale is despotically imposed, in what way is their choice widened? His "most desirable way to organize a human society" (p. 52) denies humans almost any choices. Since "free exchanges regularly mete out injustice because they do not allow people to mind their business" (p. 53), all freedom must be denied. Because "the market is giving out false information about the costs and benefits of each of our transactions" (p. 58), all our transactions must be regulated. Once regulated we will be able to enjoy "real wealth" (p. 61).

All human institutions—governments, markets, money, etc.—suffer from the same problem: the imperfections so bitterly denounced by Schmookler. Greed, ignorance, myopia, irrationality are endemic in them all. People living within such institutions may not have the choices he would like them to have, but this much should be clear: a misplaced faith in government administered according to the millennial vision of Schmookler will not improve their situation.

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## *THE END OF MONEY AND THE STRUGGLE FOR FINANCIAL PRIVACY*. BY RICHARD W. RAHN. SEATTLE AND WASHINGTON: DISCOVERY INSTITUTE PRESS. 1999

The popular media often see the technological advances of the last century as a frightening boost to the power and reach of the state. The box-office hit *Enemy of the State*, starring Will Smith, shows a government using high technology to persecute an innocent citizen. Likewise, *Gattaca* portrayed a society in which technology had almost erased personal privacy and enabled the state to suppress the most precious individual freedoms.

In contrast, Richard Rahn's view of the future of money and financial privacy is positive and exciting. If he is correct, totalitarians will suffer a massive cut in their power and reach in the next two decades. Technology has been used and abused by the state, but Rahn shows how it will be used by individuals for the enhancement of financial privacy and personal protection.

Two key technologies give the impetus to Rahn's encouraging predictions. Only in the last five years have they both come into common use, and Rahn believes that they now will force major reductions in the size and scope of civil government.

The first development was public-key cryptography, which appeared in the mid-1970s. Public-key cryptography is now easy to use, and allows secure transmissions over telephone lines. Rahn, in a primer on public-key cryptography, shows that it is relatively simple to make a code that is practically unbreakable even by governments.

The second development was the Internet (which Vice President Gore apparently intends us to believe was his brainchild). In combination with strong public-key cryptography, the Internet essentially allows any two modem-equipped computers in the world to trade information that is inaccessible by any government.

Because of these complementary technologies, it is possible for digital money substitutes to be created (publicly or privately) and exchanged worldwide without the knowledge or consent of government regulators. Paper currency will become obsolete as privacy-seekers turn to secure, instantaneous digital transactions.

International private exchange of money substitutes over the telephone allows businessmen to avoid some taxes and government regulations, which are typically geographically constrained. Many services, such as software development, architectural design, legal services, and banking services, can be provided from a distance over the Internet and service providers can move to free-market jurisdictions to avoid taxes. Writes Rahn,

> Free trade in services increasingly will become a necessity, because governments will find they can neither regulate nor tax such transactions, because consumers will

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> receive much of the "product" by way of the Internet in digitally encrypted form. Governments that fail to move to free trade in services will find they are faced with the digital equivalent of trying to sweep back the sea. (p. 30)

Rahn leaves little hope for tax collectors and financial regulators who wish to retain control. "The question is not whether we will have financial privacy—we will. The appropriate question is whether financial privacy will be legal, when, and at what price. The technological genie is out of the bottle. . . . [M]oney as we know it is going to disappear. At some point, all money and the information money conveys, will be electronic in digital form" (p. 65).

Because financial privacy is absolutely essential to liberty, it is refreshing to see Rahn hopeful about the restoration of privacy to individuals worldwide. Governments have enjoyed the ability to monitor the slightest detail of electronic financial transactions, and in some places have legally required reporting of large cash transactions. The well-worn excuse that government snooping is necessary to suppress organized crime and money laundering is spurious, Rahn shows. Suppressing organized crime through money laundering statutes is ineffective, and any small benefit that may accrue is not worth the certain loss of privacy for non-criminals.

Given the history of civil government, we cannot expect bureaucrats to use data about individual citizens only for the detection and prosecution of terrorism, theft, or fraud. Rahn discusses at some length the abuses of privilege by regulators, and shows how certain U.S. laws, such as the RICO statute (allowing federal agents to seize assets without proof of the owner's guilt) and the Bank "Secrecy" Act, result in tragic losses of privacy and private property.

Rahn opposes money laundering statutes and encryption controls of all sorts, declaring that, in any event, any attempt to limit financial privacy will soon become an absurdity. Comparing money laundering statutes to Prohibition, he writes,

> When digitized money is encrypted. . . . it is unseen. . . . Alcohol is composed of atoms, it has to be contained in a bottle or a can and it is heavy, yet, during prohibition, only a small percentage of the bootleg product was ever seized or destroyed. The problem of trying to identify "bootleg" money is infinitely harder. When government officials tell you that they can control money laundering, when they cannot even stop tons (many, many atoms) of cocaine and marijuana from crossing the border, it does not pass the laugh test. (p. 71)

Rahn is careful to delineate his argument.

> Advocating the abolition of laws and regulations that restrict financial privacy is not the same as condoning terrorism, drug dealing, or tax evasion. It is merely acknowledging that the new technology has made it impossible, at least in any reasonably cost-effective manner, to enforce such laws and restrictions and at the same time preserve civil liberties. (p. 20)

However, Rahn argues for the morality of tax evasion in some circumstances. "In Hitler's Germany," he states, "the moral person was the tax evader" (p. 169). Under the heading "When is Tax Evasion Morally Justified," Rahn states,

> An argument against financial privacy is that it will make the collection of some types of taxes more difficult for governments. This argument is indeed true, but that is not a

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> justification for preventing financial privacy; in fact, it can be an argument for *protecting* financial privacy. When a government is unjust and corrupt, the people have both the right and the duty to oppose it. A form of opposition is the refusal to fund the government to the best of one's ability, which can take the form of deliberate tax avoidance or evasion. (p. 169)

As long as Rahn is discussing the enhancement of privacy in the digital age, his arguments are credible and hopeful. However, Rahn's economic understanding is deficient in some respects. Despite an attitude toward money that would be generally acceptable to Austrian economists, Rahn displays a few inconsistencies, and a little confusion about the nature of money. In the preface, Rahn emphasizes, "Money will disappear because a circulating medium of exchange is needed only when a time interval is required between the liquidation of an earning or useful asset and the acquisition of a new asset or service. In the digital age, such time intervals are no longer needed, hence there is no need for traditional money" (p. 8). Will money disappear, as the title, and this paragraph seem to indicate? Rahn flits back and forth from discussing "the end of money" and the "non-monetary economy" to mention of the "non-governmental money" of the future and "the world of digital money." If only he were more clear. Rahn cannot mean the literal end of money, but rather the end of the use of physical currency in exchange and the end of government-issued fiat currency.

Mises has pointed out that we cannot function in a world without money. "The whole structure of the calculations of the entrepreneur and the consumer rests on the process of valuing commodities in money. Money has thus become an aid that the human mind is no longer able to dispense with in making economic calculations" (Mises 1980, p. 62). Rahn's digital money is really what Mises would refer to as a money substitute. Money substitutes, to Mises, are "those objects that are employed like money in commerce but consist in perfectly secure and immediately convertible claims to money" (p. 65). Whether these claims are printed or exist in a computer record seems to matter little in principle. Mises shows that what is important is not the physical characteristics of money and money substitutes, but the purposes they serve. In *Human Action*, Mises (1998, p. 444) writes, "Banknotes are not indispensable. All the economic achievements of capitalism would have been accomplished if they had never existed. Besides, deposit currency can do all the things banknotes do."

Rahn also still sees a role for a central bank, though he notes that it will be more disciplined by the market. In his view, government must still set a "unit of account," but he speculates that the dollar may return to a commodity standard. To Rahn (pp. 53, 54), the commodity standard would not be gold or silver, but a basket of commodities, *à la* Irving Fisher, Benjamin Graham, and F.A. Hayek (1976). If Rahn were as well-read in Rothbard as in Hayek, he would be aware that Rothbard had launched a devastating critique of the commodity dollar at least fourteen years ago, which was based on Mises's earlier work.

> There are many deep-seated flaws in this approach. In the first place, such a market-basket currency has never emerged spontaneously from the workings of the market. It would have to be imposed. . . . as a "constructivist" scheme from the top, from government, to be inflicted upon the market. Second. . . . the government would be obviously in charge, since a market-basket currency does not, unlike the units of

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> weight in exchange, arise from the free market itself. The government could and would, then, alter the ratios of weights and adjust the various fixed terms, and so forth. Third, the hankering for a fixed market basket is an outgrowth of a strong desire for the government to regulate the economy so as to keep the "price level" constant. As we have seen, the natural tendency of the free market is to lower prices over time, in accordance with growing productivity and increased supplies of goods. There is no good reason for the government to interfere. Indeed, if it does so, it can only create a boom-and-bust business cycle by expanding credit to keep prices artificially higher than they would be on the free market. (Rothbard 1977, p. 371; also Mises 1998, p. 422)

Rothbard also points out, with Mises, that there are fatal problems with the concept of "the price level." In addition, Gresham's Law would produce "perpetual shortages and surpluses of different commodities within the market basket" (Rothbard 1977, p. 372).

Rahn believes that the new digital era will bring about not only a redefinition of the dollar, but a slew of private monies as well. "People can have a choice of monies, both government-issued and privately-issued monies, which will enable them to escape from unstable money." Gold warehouses can now open and, without the knowledge or consent of government regulators, issue warehouse receipts that could, Rahn believes, circulate electronically as a viable alternative to fiat money.[1]

Rothbard, however, warns that such a Hayekian plan for the denationalization of money would not work. "Americans have been used to using and reckoning in 'dollars' for two centuries, and they will cling to the dollar for the foreseeable future. They will simply not shift away from the dollar to the gold ounce or gram as a currency unit" (Rothbard 1977, p. 369). Even during runaway inflation, Rothbard points out, "people will cling doggedly to their customary names for currency." In any case, as Rahn notes, the monetary system would still fall under the influence of the state, as people would "still be forced to use government money for the payment of taxes and for the receipt of payments from government" (ibid., p. 40). However, "for private transactions, people will increasingly move away from government money."

Rahn seems to conflate money and capital. He proposes that the "money" of the future will be instantaneously transferable securities—real working capital will be transferred instead of sterile gold or silver, so money will be interest-bearing. Rahn's definition of money is somewhat vague, and should be clarified.

Rahn's definition of inflation is also problematic. Inflation, to Rahn, is "the situation in which there is too much money chasing too few goods" (p. 39). We obtain from Mises and others the idea that every money supply is optimal—there is no such thing as "too much" money. Properly understood, inflation is the increase of the money supply.[2]

The best parts of Rahn's book are those dealing with the enhancement of privacy in the digital age. These parts are realistic and encouraging. Yet when Rahn

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[1]The Gold and Silver Reserve has already set up a legal, Internet-based service (www.e-gold.com) that is a step toward the separation of money and state.

[2]Some Austrians will also cringe at Rahn's definition of public goods, included in a discussion of the functions of a limited government: "A public good is an indivisible benefit, like constitutional rights or national defense, that *government alone* can provide and can provide only to all citizens" (p. 176; emphasis mine).

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follows Hayek in his attempts to predict changes in the monetary system that could result from technological changes, he runs into trouble. Some academic economists may be aware of the Mises–Hayek debate on money, but the average businessman for whom this book is written is not so aware and is done a disservice by Rahn's failure to note the controversy.

Rahn also tends to ramble off-topic at times, and a sizable portion of the book is dedicated to a discussion of "what is wrong with the U.S." rather than specific issues relating to digital money or even the monetary system in a broader sense. Most of what he says is consistent with a classical-liberal political position, but readers particularly interested in digital money would be better served to have the broader political issues left to another publication.

The last chapter of Rahn's book consists of a fictional tale of two countries as they might appear in 2013, after taking different paths in response to changing technology. Predictably, "Freelandia," where government took a laissez-faire approach to private finances, is a virtual utopia; and "Malapense," where government tried to squelch freedom, is a poverty-stricken nightmare. Cryptography and the Internet can be used for good or for evil. In the end, changing ideas is of far greater import than changing technology.

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# *ECONOMICS AND REALITY*. BY TONY LAWSON. LONDON AND NEW YORK: ROUTLEDGE. 1997

Tony Lawson, an economics lecturer at Cambridge University, defends a thesis sure to arouse the interest of Austrians. Mainstream economics lies crushed in the fatal grip of positivism. The futile search for constants in human behavior condemns econometrics to sterility; and economic theory as a whole is little better. It disregards the basic truth that human beings act.

Our author's thesis sounds as if it had been lifted from the pages of *Human Action*; but, so far as one can tell, Mises has exerted no influence whatever on *Economics and Reality*. Not Mises but Roy Bhaskar, a Marxist philosopher of science, is our author's guide in all matters methodological. Though he notes occasional disagreements with Bhaskar, the latter's critical realism "has proved most useful for my [Lawson's] own [project]" (p. xvi).

The book nowhere cites Mises, and Lawson's acquaintance with the Austrian School stems principally from Menger and Hayek, whose work on methodology he finds lacking by critical realist standards. But does this not make the coincidence between Mises and Lawson all the more remarkable? If our author has arrived at Misesian insights by a trek through Bhaskar's dense prose, is that not all the better? Will not his range of reference, so different from that of most Austrians, enable us to gain new insights into our own views?

Alas, this hope is not entirely fulfilled. Though Lawson's work contains many insights, these often prove to be entangled in fallacious arguments; and much of what he says about philosophy seems mistaken. For Lawson, the root of all evil is not, as another source would have it, the love of money: it is rather the deductive-nomological model of explanation.

"The main culprit," Lawson writes, "is a mode of explanation that can be referred to as deductivist, or, more particularly, it is the conception of 'laws' (or 'significant results' or 'theoretical formulations') upon which deductivist explanation ultimately depends" (p. 16).

In this view, known affectionately to philosophers of science as the D-N model, to explain something is to deduce it from initial and boundary conditions, together with a law of the form "whenever X, then Y." An example will clarify the D-N procedure. Suppose we wish to explain why Senator Edward Kennedy has introduced yet another of his interminable socialistic "reforms." We note that the Senator is a certifiable leftist; and, by hypothesis, he has perceived a social problem. These facts constitute our initial conditions.

All we need to complete our explanation is a universal law, which may readily be supplied: "Whenever a certifiable leftist perceived a social problem, he advances a socialistic program to cope with it." The Senator's behavior has been deduced from a law and a set of initial conditions: hence, it is explained.

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Lawson locates in the D-N model, when applied to economics, a fundamental mistake. Unlike the physical scientist, the economist can rarely, if ever, resort to controlled experiment. The economist confronts the same situations as the historian, as characterized by J.A. Froude. He faces an immense number of facts which, like the letters of the alphabet, can be arranged in an infinity of patterns. He cannot isolate the effect of one variable from an otherwise constant situation in order to test hypotheses of constant conjunction.

Lawson's point has merit, but it does not rule out laws of the form "whenever X then Y," so far as human action is concerned. Why cannot there be *a priori* laws of human action, in the fashion elaborated by Mises and Rothbard?

Our author does not tell us; he mentions the *a priori* only in passing.

> If in the manner suggested it turns out that philosophy can so establish synthetic *a priori* knowledge (of the sort we are hoping to achieve) it can only be in the relative or conditional sense.... [Philosophy] represents ... an investigation that necessarily takes contingent historical premises and specific social conditions, and aims to produce hypothetical and conditional conclusions. (p. 60)

Bhaskar's philosophy, no doubt, will entertain no more robust version of the *a priori* than Lawson offers. I cannot think, though, that our author's adoption of Bhaskar's view justifies his *a priori* neglect of the Misesian position.

No doubt Lawson will respond that he here follows simple common sense. Human action of necessity involves choice. If so, how can it obey invariable laws? "An interesting question to pursue, then, is what is implied by the reality of people making choices? Now if choice is real any agent could always have done otherwise ... if under conditions X an agent in fact chose to do Y, it is the case that this same agent could really instead have not done Y" (p. 30).

Let us suppose that Lawson is entirely right: whenever I choose to do act A, I might have refrained from so doing. How does it follow from this that there are no *a priori* laws of action? No doubt such laws, if they exist, will not necessitate the outcomes of particular choices; but why must a law of human action assume this suspect form? I should have thought, once more, that the work of Mises and Rothbard offers much evidence to the contrary.

But, it may be replied, this mistakes Lawson's essential claim. His target is not the Misesian *a priori*, but the constant conjunctions beloved of logical positivists. As these philosophers and the economists who follow in their wake see matters, laws merely state that one sort of fact always follows another. No claim to discern an inner necessity is bring made. But, if laws are taken in this way, Lawson's appeal to freedom fails of its purpose. His argument, I take it, is this: A supposed law of action says that whenever X takes place, then Y will occur. But if Y is an act of free choice, it is always possible that Y does *not* occur. To deny this flies in the face of free choice. How then can one maintain that a law always holds? The occurrence of Y is *not* inevitable.

This argument rests crucially on an equivocation. What does "inevitable" mean? If it means that Y *must* follow X, that given X, then Y cannot fail to happen, then the supposed law does indeed deny free choice as our author conceives it. If Y *had* to happen, then it is false that Y *might not* have happened. So much is evident. But it is equally evident, I fear, that this consideration leaves the positivist unscathed. On Lawson's own showing, he claims that Y always follows X. He does *not* claim that X

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and Y are of necessity conjoined; where then is the problem that free choice poses for his view?

And there is yet another instance in which Lawson's critique aims at the wrong target. He wishes to combat Humean causal laws. The laws of science appeal to essences: they tell us what it is in the nature of things to do. (On this view of causal laws, there cannot be scientific laws that dictate the outcomes of free choices, since one cannot freely act against one's nature.)

Devotees of *Man, Economy, and State* will applaud Lawson's contention. But what does this have to do with the D-N model? Why does a supporter of this position have to appeal to laws of constant conjunction, rather than to essences or natures? No doubt Carl Hempel and Karl Popper, the foremost advocates of the D-N model, did have the suspect view of causal law. But this is a mere conjunction; Lawson demonstrates no essential connection between the D-N model and Humean view of causal laws.

In like manner, why cannot a proponent of the D-N model make use of structures in his explanation? We touch here on a key point in Lawson's presentation. As he sees matters, positivists are confined to the surface. They search for regularities in what is given to the senses, but they ignore the structures that give rise to these appearances. What underlies the regularities of sense? Here is a question, Lawson avers, that positivists cannot answer. Since they do not admit natures and powers of objects into their ontology, they cannot cope with structure.

Once more, why is this a problem for the D-N model view? Why cannot a supporter of this view appeal to structures, in just the sense that our author does?

One might here object in this way. Suppose that Lawson has wrongly connected the D-N model with the view of causal necessity he opposes. What is that to us? Why should we be so anxious to defend the D-N model?

The answer lies not (I hope) in an unconscious sympathy on my part for positivism. Rather, if the D-N model is rejected, what is the alternative account of explanation our author wishes us to use? He may wax eloquent about nature and structure all he wishes; but a question remains for his analysis. What exactly is supposed to be the connection between the essence or structure and the surface events it is alleged to explain? If the connection is *not* that the surface events follow deductively from the structures, what is it? Lawson owes us an alternative account of explanation. If not D-N, what then?

But has not Lawson given us an adequate response? True, he gives us no theoretical account of how structures explain events non-deductively. Nevertheless, he answers the question by illustration: *solvitur ambulando*. Does not his elaborate historical account of the slow growth of British productivity during the last hundred years show us exactly what he means by explanation (p. 255ff)? And may we not go further? Does he not give a detailed account of how his explanation operates? Must not the charge that he has failed to offer an alternative to the D-N model be withdrawn?

As it seems to me, the accusation against him stands good. He devises an intricate technical vocabulary to describe the historical account he provides. (Readers who wish to find out what a "contrastive demi-reg" is may consult the text).

But he does not, to repeat, show us how all this apparatus explains slow British productivity, if not by enabling us to deduce it from laws. A proponent of D-N

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would claim that Lawson's historical narrative can readily be accommodated by his model. If not, why not?

Further, even some of Lawson's criticism of the Humean view of causation misfires. Why cannot a Humean appeal to underlying levels and structures? These structures will, by hypothesis, not involve causal necessities stricter than constant conjunction, but why is this to the point? To say that causation is constant conjunction is not to say that we cannot stray from what appears to the senses.

Austrians have a ready answer to those who demand of us why we ought to proceed in praxeological fashion. The axiom of action, and what follows deductively from it, are true. Are the results of Austrian analysis illuminating as well as true? Those in search of an answer have available the treatises of Mises and Rothbard for study.

What has Lawson to show to skeptics who ask why we should pursue economics according to the critical realism of Bhaskar? Our author rejects much of mainstream economics; for him a truly scientific economics is largely a project for the future. He cannot then appeal to a developed body of economic theory to show why the methodology he supports ought to be adopted.

Instead, he resorts to an argument from analogy. Bhaskar, he tells us, has endeavored to answer a transcendental question: how is physical science possible? Bhaskar's response brings in the whole apparatus of structures and essences about which I have been able only to hint at in this review.

To see what is at stake here, we must grasp the underlying situation, as Bhaskar and his disciple Lawson conceive it. The question, "how is physical science possible?" depends for its interest on the premise that physical science is a highly successful enterprise. The question, "how is astrology possible?" is of much less interest.

Here arises a fatal problem, so far as economics is concerned. In Lawson's view, mainstream economics is *not* a successful discipline. He does not, in analogy to Bhaskar, ask how is existing economics possible? To do so in his view would not generate results of interest. Instead, Lawson conjectures that the conditions under which physical science is possible, according to Bhaskar, will also prove capable of generating a science of economics. Once more, no such discipline yet exists. Our author's entire edifice, on his own showing, rests on the merest conjecture.

Of this Lawson is well aware. In contrast with physical science, "the actuality of a social science cannot be taken as given or uncontentious. Rather, we are questioning its possibility, and the best we can do is take the (correctly) most adequate account of (natural) science as conditioning" (p. 56). In brief, critical realism explains physical science; maybe it will enable us to construct a viable economics as well. This hardly seems a sound basis for economics. To paraphrase Edith Cavell, anti-positivism is not enough.

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